

Notes 2

FINANCIAL STATEMENTS

Financial Statements

- The accounting and financial regulatory authorities (SEC for a public firm, IRS for a private firm) mandate the following four types of financial statements:
 1. Income statement
 2. Balance sheet
 3. Cash flow statement
 4. Statement of shareholder's equity

Financial Statements

- Public companies are required to submit the financial statements using the Generally Accepted Accounting Principles –GAAP

Definition - Generally Accepted Accounting Principles –GAAP

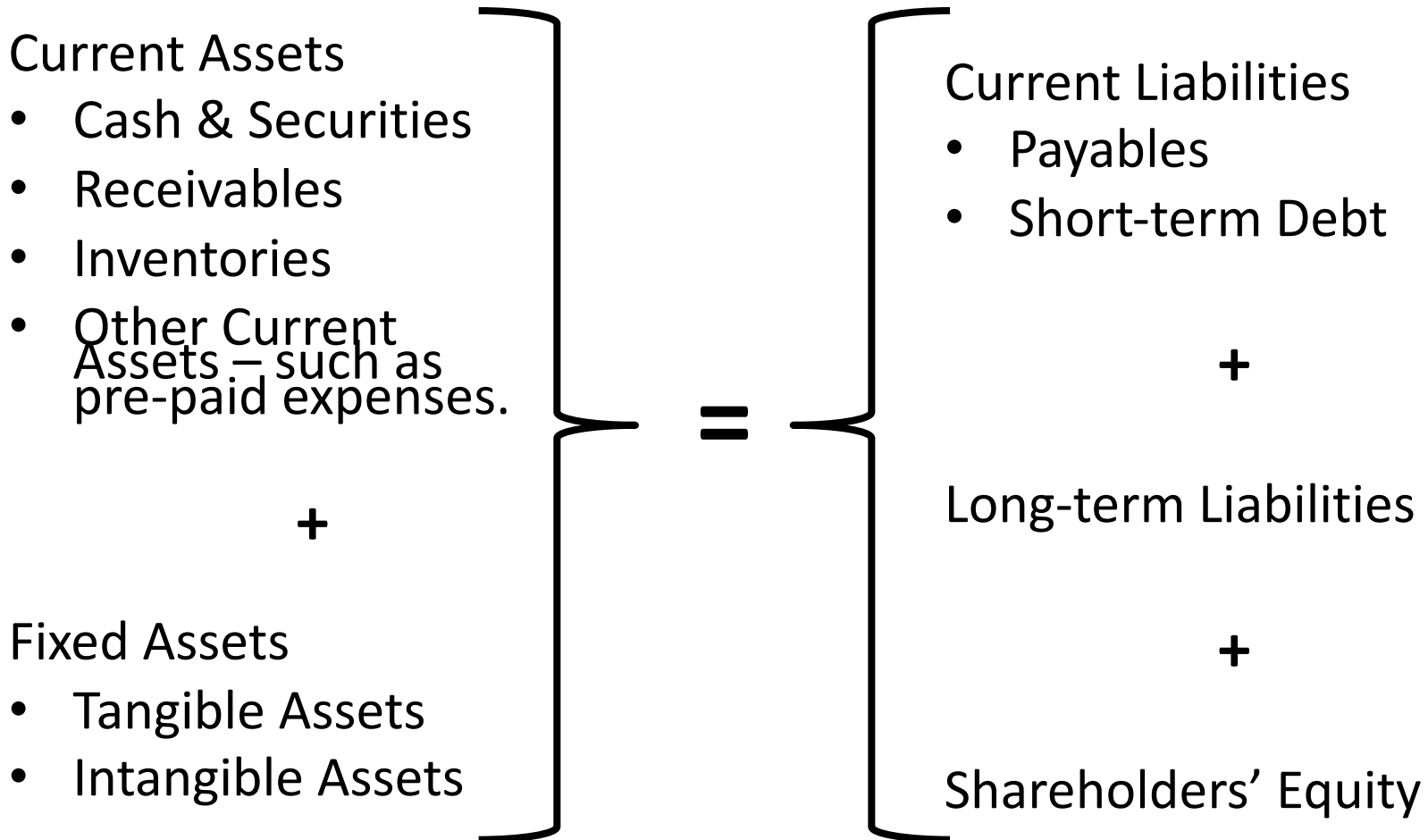
Procedures for preparing financial statements

Definition – Balance Sheet

Financial statement that shows the value of the firm's assets and liabilities at a particular time (from an accounting perspective)

Financial Statements - Balance Sheet

The Main Balance Sheet Items



Financial Statements - Balance Sheet

GLOBAL CONGLOMERATE CORPORATION

Consolidated Balance Sheet
Year Ended December 31 (in \$ million)

Assets	2018	2017
Current Assets		
Cash	21.2	19.5
Accounts receivable	18.5	13.2
Inventories	15.3	14.3
Other current assets	2.0	1.0
Total current assets	57.0	48.0
Long-Term Assets		
Land	22.2	20.7
Buildings	36.5	30.5
Equipment	39.7	33.2
Less accumulated depreciation	(18.7)	(17.5)
Net property, plant, and equipment	79.7	66.9
Goodwill and intangible assets	20.0	20.0
Other long-term assets	21.0	14.0
Total long-term assets	120.7	100.9
Total Assets	177.7	148.9

GLOBAL CONGLOMERATE CORPORATION

Consolidated Balance Sheet
Year Ended December 31 (in \$ million)

Liabilities and Stockholders' Equity	2018	2017
Current Liabilities		
Accounts payable	29.2	24.5
Notes payable/short-term debt	3.5	3.2
Current maturities of long-term debt	13.3	12.3
Other current liabilities	2.0	4.0
Total current liabilities	48.0	44.0
Long-Term Liabilities		
Long-term debt	99.9	76.3
Capital lease obligations	—	—
Total debt	99.9	76.3
Deferred taxes	7.6	7.4
Other long-term liabilities	—	—
Total long-term liabilities	107.5	83.7
Total Liabilities	155.5	127.7
Stockholders' Equity	22.2	21.2
Total Liabilities and Stockholders' Equity	177.7	148.9

Financial Statements - Balance Sheet

- Book Value of Equity = Book Value of Assets – Book Value of Liabilities
- **Could possibly be negative**
- Note that the assets are book value, and not market value. For example, It could be that there is a building that was purchased for 1 million \$ (book value) but the market value today is much more than 1 million \$.

Financial Statements - Balance Sheet

- *Market Value of Equity (Market Capitalization)=
Market Price per Share x Number of Shares Outstanding*
- **Cannot be negative**
- Often differs substantially from book value

Balance Sheet - Example

- According to GAAP, your firm has equity worth \$3 billion, debt worth \$1 billion, assets worth \$4 billion. The market values your firm's 100 million shares at \$75 per share and the debt at \$1 billion. What is the market value of your assets?

Balance Sheet - Example

- Since (Assets = liabilities + equity), your assets must have a market value of \$8.5 billion:
- Book Value Balance Sheet

Assets = \$4 bil

Debt = \$1 bil

Equity = \$3 bil

Total = 4 bil

Total = 4 Bil

- Market Value Balance Sheet

Assets = ?

Debt = \$1 bil

Equity = \$7.5 bil

Total = ?

Total = 8.5 Bil

Income Statement

- An income statement provides information for a specific period of time (for example, a full year or quarterly) about the total revenue (sales) minus many types of costs equals to net profit.

Income Statement

GLOBAL CONGLOMERATE CORPORATION

Income Statement Year Ended December 31 (in \$ million)

	2018	2017
Total sales	186.7	176.1
Cost of sales	(153.4)	(147.3)
Gross Profit	33.3	28.8
Selling, general, and administrative expenses	(13.5)	(13.0)
Research and development	(8.2)	(7.6)
Depreciation and amortization	(1.2)	(1.1)
Operating Income	10.4	7.1
Other income	—	—
Earnings Before Interest and Taxes (EBIT)	10.4	7.1
Interest income (expense)	(7.7)	(4.6)
Pretax Income	2.7	2.5
Taxes	(0.7)	(0.6)
Net Income	2.0	1.9
Earnings per share:	\$0.556	\$0.528
Diluted earnings per share:	\$0.526	\$0.500

Statement of Cash Flows

- Net Income typically does NOT equal the amount of cash the firm has earned. For example, Depreciation and Amortization is an accounting expense.

Definition – Cash flows statement

Financial statement that shows the firm's cash receipts and cash payments over a period of time

Statement of Cash Flows

- Net Income typically does NOT equal the amount of cash the firm has earned.
 - Non-Cash Expenses
 - Depreciation and Amortization
 - Uses of Cash Not on the Income Statement
 - Investment in Property, Plant, and Equipment

Statement of Cash Flows

1. Operating Activity

- Depreciation – add the amount of depreciation
- Accounts Receivable – deduct the increases
- Accounts Payable – add the increases
- Inventories – deduct the increases

2. Investment Activity

- Capital Expenditures
- Buying or Selling Marketable Securities

3. Financing Activity

- Payment of Dividends
- Changes in Borrowings

Statement of Cash Flows

GLOBAL CONGLOMERATE CORPORATION

Statement of Cash Flows Year Ended December 31 (in \$ million)

	2018	2017
Operating activities		
Net income	2.0	1.9
Depreciation and amortization	1.2	1.1
Other non-cash items	0.2	1.0
Cash effect of changes in		
Accounts receivable	(5.3)	(0.3)
Accounts payable	4.7	(0.5)
Inventory	(1.0)	(1.0)
Other net operating assets	(3.0)	(2.0)
Cash from operating activities	(1.2)	0.2
Investment activities		
Capital expenditures	(14.0)	(4.0)
Acquisitions and other investing activity	(7.0)	(2.0)
Cash from investing activities	(21.0)	(6.0)
Financing activities		
Dividends paid	(1.0)	(1.0)
Sale (or purchase) of stock	—	—
Increase in borrowing	24.9	5.5
Cash from financing activities	23.9	4.5
Change in cash and cash equivalents	1.7	(1.3)

Statement of Cash Flows

- In 2016, Rylan Enterprises depreciation expense decreased by \$750,000. Rylan's total corporate tax rate is 40%.
- How did the decline in Rylan's depreciation expense impact its end-of-year cash balance?

Statement of Cash Flows

- The pretax income is up by 0.75 million.
- Tax goes up by $40\% * \$0.75 \text{ million} = \0.3 million .
- Therefore, net profit goes up by $= \$0.75 \text{ million} - \$0.3 \text{ million} = \$0.45 \text{ million}$.
- The cash flows changes by $\$0.45 \text{ million} - \$0.75 \text{ million} = -\$0.3 \text{ million} = -\$300,000$.