

FIN 303 Hybrid - Professor Dow

Financial Statements

Why financial statements?

- Taxes
- Internal
- External :
 - equity investor,
 - creditor

Financial statements are important for a number of reasons. Companies have to keep records to determine their tax obligations. Internally, managers in the company might be interested in questioning how efficiently the company is run and whether there might be some way to improve that. External investors would also be interested in the financial condition of the company. Someone who is interested in buying the company's stock might want to know how profitable a company is and how that might change in the future. A bank that is considering lending the company money to finance an expansion would want to know if the company will be able to repay the loan in the future.

The Big Three Financial Statements

- Income Statement
- Balance Sheet
- Statement of Cash Flows

In this class, we will be concerned with the three primary financial statements, the income statement, the balance sheet and the statement of cash flows. We'll go through each briefly, but this is just review; you should be familiar with the various financial statements from your financial accounting class.

Income Statement

Revenue
- Costs
= Earnings

The income statement is structured around the relationship that revenue less costs equal earnings (or income). Actual income statements will be more complicated than this as they will provide more detail about the sources of revenue and costs. Often the extra detail is there to provide answers to specific questions financial analysts might have.

Example:

- Separating costs into costs of goods sold and overhead

\$500 Revenue
- \$300 Costs of goods sold
- \$200 Overhead
= \$0 Earnings

One way to break down costs is to separate fixed from variable costs. In this example, the company's costs come from overhead, which is fixed, and the costs of manufacturing the goods, which varies with the amount produced. Currently the company has zero earnings, but because revenue is above the costs of goods sold, if it could increase production it could generate positive profits. If we were thinking about investing in this company, we would want to assess its prospects for sales growth to forecast future profitability.

Example:

- Separating out extraordinary revenue

\$800 Revenue

 \$300 from one-time contract

- \$700 Costs

 \$100 from one-time contract

= \$100 Earnings

In this example we have a company that generated \$800 in revenue but \$300 of that came from a one-time contract. If we were considering investing in this company we would want to use the income statement (and other information) to estimate it's future profitability. The catering job was very profitable, but since the company doesn't expect this to happen again, this year's income statement would not be a good predictor of the future. To come up with a better estimate, we would want to remove the revenue and costs from the one-time contract and only rely on the "typical" earnings. In this case, without the one-time contract, the company would have lost money.

Balance Sheet

Assets
- Liabilities
= Equity

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

There are two basic ways to look at a balance sheet. From the net worth perspective, we can determine the value of owner's equity in the company by the value of the assets of the company less the amount that it owes others. This is called the "book" value of the company since it's based on the financial statements or "books" of the company. As we'll see in the valuation section of the course, there are other ways to value a company, for example by looking at the cash flow generated by the assets of the company, but the balance sheet provides a useful place to start.

An alternate way of looking at the balance sheet is from the perspective of the financing the firm. A firm can finance its assets by either issuing equity or debt and so the balance sheet arranged as a T-account (with assets on one side and liabilities and equity on the other) shows the amount of money raised and the mix of equity and debt used.

Like the income statement, the balance sheet will break down assets and liabilities into their components. Assets and liabilities with a maturity of a year or less (known as current assets and current liabilities) are listed before long-term items.

Some points about the balance sheet

- Values are for a particular day
- Book vs. market

Unlike the income statement and the statement of cash flows, which report numbers over a period of time such as a year, the balance sheet reports values at a moment of time, typically at the end of a quarter or the end of a year. Because of this, some companies can structure their balance sheet to look particularly good on the day that they report the numbers, a practice known as “window dressing”.

For the most part, values on the balance sheet are what are known as “book” values, that is they are from the financial books and based on historical data. For example, if the company buys a piece of land, its book value is determined by what the company paid for it, not by what it could sell it for in the market now. As financial analysts, we care about what the property is worth now so we would rather know the market value than the book value. Some companies report the value of some assets as estimates of what they could get for it in the market, which is called mark-to-market accounting. Knowing this information can be very valuable; however, there can also be problems coming up with reliable estimates of the market value of some items if there is not an active market for the asset.

Statement of Cash Flow

- Cash flow comes from:
 - Operating Activities
 - Investing Activities
 - Financing Activities

In the end we care about the amount of cash generated by the company. Cash may be different from earnings either because there are non-cash items in the income statement, such as depreciation, or there are ways of generating cash that are not reported on the income statement. The statement of cash flows summarizes the movement of cash in and out of the company.

Cash flows are separated into three categories:

Operating activities are those associated with the general business activities of the company as are typically reported on the income statement. The products or services a company sells generates operating cash flow.

Investing activities are associated with changes in the assets of a company. If a company buys a new factory this increases the assets of the company but represents a cash outflow, that is, a negative cash flow. If a company sells assets, that generates a positive cash flow. If a company is generating positive cash flow through investing activities this may not be a good sign since selling off assets now may reduce the ability of the company to generate operating cash flow in the future.

Financing activities are cash flows associated with raising cash from investors or returning cash to investors. For example, borrowing money generates positive cash flow while repaying a loan generates negative cash flow. If a company is generating positive cash flow through financing activities, it is important to determine whether the assets purchased by this cash will be able to generate positive operating cash flows in the future, otherwise this cash flow will be difficult to sustain.