Shivi

This presentation is a part of **Shivi:**
CFA Level I Prep Course

- To access the entire CFA Level I course materials: video lectures, notes, slides, mock exams, and many more……
- **Visit: www.shivi.org/cfa**

S H I V I

Financial Reporting & Analysis

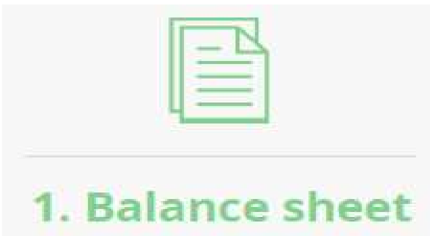
An Introduction:-

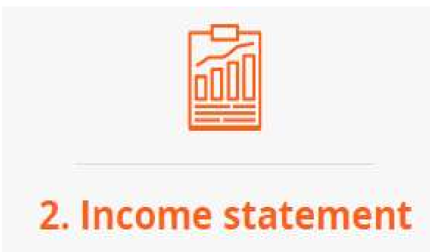
Role of Financial Reporting:-

"The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit."

- IASB (International Accounting Standards Board)

Key Financial Statements





1) **<u>Balance Sheet:</u>** Statement of financial position

- Assets
- Liabilities
- Equity

2) **<u>Income Statement:</u>** Statement of profit & loss

- Revenues
- Expense
- Profit/Loss

3) **<u>Statement of Cash Flows:</u>** Cash Flow Statement

- Operating
- Investing
- Financing

4) Statement of comprehensive income: reports all the changes in equity except for shareholder transactions.

5) **Statement of changes in owners' equity:** Amounts and sources of changes in shareholders equity over the period

What ELSE is present in a financial statement?

✓ **Footnotes and Supplementary Schedules**

What ELSE is important for evaluating a financial statement?

✓ **Management Discussion and Analysis**

Audit Report

Audit: Independent review/examination of a company's financial statements

Why is it necessary?

- To assure that the financial statements are free of materials or human errors

Outcomes:

- **Audit Opinion** – refers to a certification accompanying financial statements and is provided by the auditor.

Balance Sheet

1) **Balance Sheet:** Statement of financial position
- Assets
- Liabilities
- Equity

2) **Income Statement:** Statement of profit & loss
- Revenues
- Expense
- Profit/Loss

3) **Statement of Cash Flows:** Cash Flow Statement
- Operating
- Investing
- Financing

Balance Sheet

- Also known as **Statement of financial position** or **statement of financial condition**.
- A Balance Sheet **must always balance** i.e. **Assets = Liabilities + Owner's Equity**
- To ensure that Balance Sheet is Balance; accountant use **Double Entry Accounting** method.

Total Assets	Total liabilities & equity
Current Assets (=<1yr) **eg:** cash, inventory, accounts receivables	**Current liabilities (=<1yr)** **eg:** accounts payables
Non-current Assets (> 1 yr) **eg:** PP&E (Property, Plant & Equipment), Technology, patents, trademarks 1. **Tangible** 2. **Intangible**	**Non-current liabilities (>1 yr)** **eg:** long-term debt **Shareholders' equity** **eg:** common shares and retained earnings

Assets	
Current Assets	
Cash	24,000
Accounts receivable	4,000
Inventory	50,000
Prepaid expenses	10,000
Total current assets	88,000
Non-current Assets	
Property Plant & Equipment	100,000
Intangible assets	10,000
Total non-current assets	110,000
Total assets	198,000

Liabilities	
Current Liabilities	
Accounts payables	5,000
Accrued Expenses	2,000
Total current liabilities	7,000
Non-current Liabilities	12,000
Bank loan	90,000
Shareholder Equity	
Common shares	80,000
Retained Earnings	11,000
Total liabilities and Shareholder Equity	200,000

Understanding Balance Sheet

Understanding Balance Sheet

Assets

Definition: Flow of future economic benefits to the entity

Example:

- Cash & cash equivalents
- Inventories
- PP&E
- Financial assets
- Intangible assets
- And, many more….

Understanding Balance Sheet

Liabilities

Definition: Probable sacrifice of future economic benefits to the entity.

Example:
- Bank loans
- Accounts payable
- Tax liabilities
- Unearned revenues
- Financial liabilities
- And, many more….

Understanding Balance Sheet

Equity

Definition: Asset – Liabilities = Equity (Assets – Liabilities = Net assets)

Characteristics:

- Permanent
- No mandatory charges against earnings

Balancing the Balance Sheet

Two options:

1. Record the transaction on both sides of the balance sheet

Assets	
Current Assets	
Cash	(200)
Non-current Assets	
Total assets	(200)

Liabilities	
Current Liabilities	
Short term debt	(200)
Non-current liabilities	
Shareholder Equity	
Total liabilities & SE	(200)

Balancing the Balance Sheet

Two options:

2. Record the transaction twice on the same side of the balance sheet as both positive and negative number

Assets	
Current Assets	
Cash	(200)
Non-current Assets	
Equipment	200
Total assets	0

Liabilities	
Current Liabilities	
Non-current liabilities	
Shareholder Equity	
Total liabilities & SE	0

S H I V I

Balancing the Balance Sheet

Recording transaction on Balance Sheet example

SVM engaged in the following transaction:

1. Issued shares for 400 in Cash
2. Took out a five-year bank loan of 40
3. Bought equipment for 100
4. Bought inventory for 100
5. Sold all the inventory for 150
6. Paid Salaries for 80
7. Paid interest of 7

Record the above transaction on the balance sheet. Keep in mind that the balance sheet is **always balance i.e. Assets = Liabilities + SE**

Balancing the Balance Sheet

Step 1: Issued shares for 400 in Cash

Assets	
Current Assets	
Cash	400
Non-current Assets	
Total assets	400

Liabilities	
Current Liabilities	
Non-current liabilities	
Shareholder Equity	
Common equity	400
Total liabilities & SE	400

Balancing the Balance Sheet

Step: 2 Took out a five-year bank loan of 40

Assets	
Current Assets	
Cash (400+40)	440
Non-current Assets	
Total assets	440

Liabilities	
Current Liabilities	
Non-current liabilities	40
Shareholder Equity	
Common equity	400
Total liabilities & SE	440

Balancing the Balance Sheet

Step: 3 Bought equipment for 100

Assets	
Current Assets	
Cash (400+40-100)	340
Non-current Assets	
Equipment	100
Total assets	440

Liabilities	
Current Liabilities	
Non-current liabilities	40
Shareholder Equity	
Common equity	400
Total liabilities & SE	440

Balancing the Balance Sheet

Step: 4 Bought inventory for 100

Assets	
Current Assets	
Cash (400+40-100-100)	240
Inventory	100
Non-current Assets	
Equipment	100
Total assets	440

Liabilities	
Current Liabilities	
Non-current liabilities	40
Shareholder Equity	
Common equity	400
Total liabilities & SE	440

Balancing the Balance Sheet

Step: 5 Sold all the inventory for 150

Assets	
Current Assets	
Cash (400+40-100-100+150)	390
Inventory (100-100)	0
Non-current Assets	
Equipment	100
Total assets	490

Liabilities	
Current Liabilities	
Non-current liabilities	40
Shareholder Equity	
Common stock	400
Retained earnings	50
Revenues	150
Cost of Sales	-100
	450
Total liabilities & SE	490

Balancing the Balance Sheet

Step: 6 Paid Salaries for 80

Assets	
Current Assets	
Cash (400+40-100-100+150-80)	310
Inventory (100-100)	0
Non-current Assets	
Equipment	100
Total assets	410

Liabilities	
Current Liabilities	
Non-current liabilities	40
Shareholder Equity	
Common stock	400
Retained earnings	(30)
Revenues	150
Cost of Sales	(100)
Salaries	(80)
	370
Total liabilities & SE	410

Balancing the Balance Sheet

Step: 7 Paid interest of 7

Assets	
Current Assets	
Cash (400+40-100-100+150-80-7)	303
Inventory (100-100)	0
Non-current Assets	
Equipment	100
Total assets	403

Liabilities	
Current Liabilities	
Non-current liabilities	40
Shareholder Equity	
Common stock	400
Retained earnings	(37)
Revenues	150
Cost of Sales	(100)
Salaries	(80)
Interest	(7)
	363
Total liabilities & SE	403

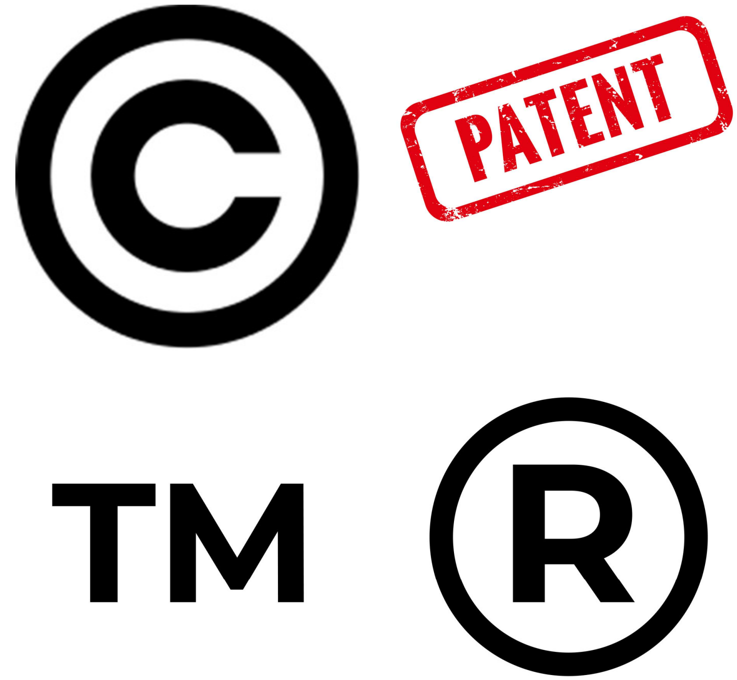
Understanding Balance Sheet

ASEETS	LIABILITIES
Current	**Current**
Expected to be converted into cash in less than 1 year eg: Accounts receivables, inventory	Will be paid in less than 1 year eg: Accounts payables
Non-current	**Non-current**
Expected to be held greater than 1 year eg: PP&E	Repayment terms longer than 1 year eg: bank loan repayable over a 4 year period

Understanding Balance Sheet

Intangible Assets

Intangible assets are items that have value and are used **to generate revenues but have no physical existence.**



Trademark *Registered Trademark*

What is a goodwill?

- **Goodwill = Acquisition price – Market Value (Fair) of the acquired firm net asset**
- **Meaning:** If a company is **purchased for more** than the fair value of **net assets**
- The additional amount paid represents the amount paid for assets which cannot be recorded on the Balance Sheet such as non-current asset or company intangible assets. For example: patents, trademarks, brand loyalty, etc.
- Fair value is decided on the sole discretion of the management.

Understanding Balance Sheet

Goodwill numerical example:

SVM Corp. paid $400 million for the outstanding stock of Shivi Group. At the time of acquisition, Shivi reported the following balance sheet (condensed):

Shivi Condensed Balance Sheet	Book Value (in millions)
Current Assets	$50
PP&E	$540
Goodwill	$22
Liabilities	$280
Equity	$400

The fair value of the PP&E was $90 million more than its recorded book value. The fair values of all other identifiable assets & liabilities were equal to their recorded book values. Calculate the amount of Goodwill SVM Corp. should report on its condensed Balance Sheet?

Goodwill numerical example:

Solution:

	Book Value (in millions)
Current Assets	$50
PP&E (Net = $540 + 90 = $630)	$630
Liabilities	($280)
Fair Value of Net Assets	$960
Purchase Price	$400
Less: Fair Value of Net Assets	($280)
Aquistion Goodwill	**$120**

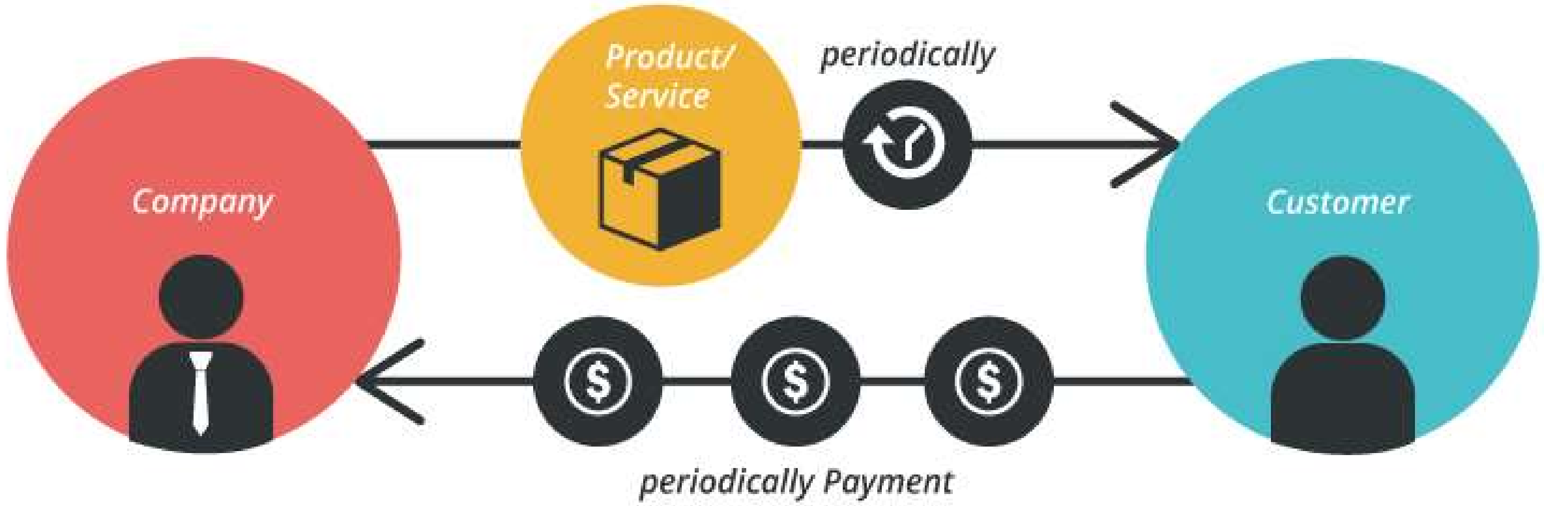
Depreciation and Depletion

Tangible assets value (for example value of equipment) decreases over time which is known as **Depreciation.** (Land is not depreciated)

- Depreciation is the allocation of tangible assets over time.

Natural resources are consumed/used up over time which is known as **Depletion.**

- Depletion is the allocation of the cost (per unit) of natural resources as they are used.



Understanding Balance Sheet

Unearned Revenue

Unearned revenue arises on a balance sheet when a company sells something it has not yet delivered

Eg: **subscriptions**, **licenses**, etc.

Commitments

Commitments are future obligations that a company agrees to.
Eg: New buildings, leasehold improvements, etc.

Contingencies

Contingencies are liabilities that may or may not happen, depending on circumstances.
Eg: Lawsuits
The liability must be recorded if:

- A **loss** will be suffered in the future.
- The loss **amount** can be reasonably estimated. (If NOT, just disclose a note)

Contingent gains are never recorded in financial statements.

Understanding Balance Sheet

Common Shares	Preferred Shares
✓ Can participates in the profits of the company, usually in the form of dividends (declared as per company discretion)	✓ Offers investors a fixed dividend.
✓ Voting rights are available	✓ Voting rights not available
✓ Common shareholders are the last resort i.e. if a company gets dissolved, any residual amount left will be paid to them	✓ Will accumulate/pay before common shareholders
✓ Most company issue common shares to raise capital	✓ Most company does not issue as they are viewed as a tax disadvantage (because paying fixed dividends does not reduce taxable income)

Understanding Balance Sheet

Authorized shares vs Outstanding shares

The full disclosure principle

For full disclosure:

Notes are provided to allow the reader of the financial statements to understand and make judgements of financial activities of the company.

Financial Assets/Liabilities

- Stocks
- Bonds
- Receivables
- Notes receivable
- Notes payables
- Loans
- Derivatives
- Many more….

Financial Assets/Liabilities

Financial Assets:-

- Available for sale securities
- Trading securities
- Assets with fair value exposures hedged with derivatives
- Derivatives (standalone or embedded in a non-current derivative instrument)

Financial Liabilities:-

- Loans
- Payables, etc.

Marketable Securities

Marketable securities can be classified based on the company's **intent** with regards to selling (**eventual sale**) of the securities.

3 types:-

1. Held-to-maturity securities
2. Available for sale securities
3. Trading securities

Marketable Securities

I. Held-to-maturity securities

- Those ***debt securities** that the company **intends** to hold to maturity

- Example: **Bonds, Certificate of Deposits (CD)**, these have maturity dates and are usually held to maturity.

***Debt securities** refers to a **debt instrument**, such as government bond, corporate bond, certificate of deposit (CD), municipal bond, or preferred stock, that can be bought or sold b/w two parties and has basic terms **defined,** such as **maturity,** notional amount (amount borrowed), interest rate, and maturity and renewal date.

Marketable Securities

II. Available-for-sale securities

- May be sold to satisfy company needs i.e. Financing Instruments
- Financing Instruments can be a debt or equity for the purpose of financing business operations.
- Can be current or non-current
- Carried on balance sheet at market value

Marketable Securities

III. Trading Securities

- Are securities that have been purchased by a company for the purpose of realizing a short-term profit.

- Can choose to speculate b/w debt or equity securities, if it identifies an undervalued security and wants to capitalize upon the opportunity.

Liquidity Ratios

- Liquidity ratios are financial ratios that measure a company's ability to repay both short- and long-term obligations. Common liquidity ratios include the following

❑ Current ratio: measures a company's ability to pay off short-term liabilities with current assets

$$\text{Current ratio} = \frac{Current\ assets}{Current\ liabilities}$$

❑ Quick ratio: measures a company's ability to pay off short-term liabilities with quick assets

$$\text{Quick ratio} = \frac{Current\ assets - Inventory}{Current\ Liabilities}$$

❑ Cash ratio: measures a company's ability to pay off short-term liabilities with cash and cash equivalents

$$\text{Cash ratio} = \frac{Cash + Marketab\quad securities}{Current\ Liabilities}$$

Solvency Ratios

Solvency Ratios: measure the amount of capital that comes from debt. In other words, leverage financial ratios are used to evaluate a company's debt levels

- Long-term debt to equity = $\frac{Total\ long{-}term\ debt}{Total\ equity}$
- Debt to equity = $\frac{Total\ debt}{Total\ equity}$

What next?

- Please do the **Balance Sheet Quiz** via *your student access portal*.

- We will be discussing more about Balance Sheet, its application and solve numerical question in our **Q&A Session.**

- We will next cover Income Statement, Cash Flow Statement, and many more…. In coming video lectures in your CFA Level I Prep course.

Thank you!

www.shivi.org/cfa