Financial Statements

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Agenda

I. Financial Statements Overview
   I. Income Statement
   II. Balance Sheet
   III. Statement of Cash Flows
   IV. Financial Statement Relationships
II. Financial Ratios
III. Fun with Return on Equity (ROE)
IV. Questions

Financial Statements

SECTION I

Why Financial Statements Matter

- Financial Statements give us a way to measure the economic performance of a company
  - To provide information to investors and stakeholders to give insight into management's performance
  - "Management's report card"
  - There are three important statements, each of which provide different insight on how management is doing
    - Income Statement
    - Balance Sheet
    - Statement of Cash Flows
- Financial Statements of public companies are standardized
  - Must follow Generally Accepted Accounting Principles (GAAP)
    - Most Canadian companies will be switching over to International Financial Reporting Standards (IFRS)

Income Statement

Peak Roofing Co. Income Statements ($000) For the years ended December 31	1991	1992	1993	1994	1995	1996	1997	1998
Sales	9,382	10,720	12,316	15,548	17,379	22,520	23,640	22,558
Less: Cost of Goods Sold	6,902	7,895	9,189	12,008	13,430	17,781	18,787	17,635
Gross Profit	2,480	2,825	3,127	3,540	3,949	4,739	4,853	4,923
Less: Operating Expenses								
General & Administrative Expense	1,687	2,166	2,505	2,758	2,902	3,644	3,727	3,737
Lease & Rental Expense	85	90	90	90	94	94	93	92
Depreciation	206	207	226	244	352	359	399	436
Total Operating Expenses	1,978	2,463	2,821	3,092	3,348	4,097	4,219	4,265
Operating Income	502	362	306	448	601	642	634	658
Less: Interest Expense	100	101	73	63	300	316	342	422
Other Income	145	150	197	231	192	231	256	269
Less: Extraordinary Expense	0	0	0	0	0	0	0	0
Profit Before Tax	547	411	430	616	493	557	548	505
Less: Taxes	137	103	95	129	172	28	104	147
NET PROFIT	410	308	335	487	321	529	444	358

Income Statement

- Statement of a company's profitability over a specific **period of time**
- Key points:
  - Revenue recognition is highly subjective
    - Based on Cash Received
    - Based on Products Sold
    - Based on Production
  - Cost of good sold depends on cost estimation and allocation methods
  - Depreciation depends on estimation of useful life and salvage value of asset
    - Adjustments can occur from technological advances and reliability issues
  - Taxes only paid on income, losses can be carried forward to offset future taxes
  - Earnings per Share (EPS) =

$$\frac{\text{Net Income}}{\text{Weighted Average Common Shares Outstanding}}$$

    - One of the most followed financial statistics
  - Operating Profit = Earnings Before Interest and Tax (EBIT)
  - Earnings Before Interest Tax Depreciation and Amortization (EBITDA)

Balance Sheet

Peak Roofing Co.
Balance Sheet ($000)
As at December 31

	1991	1992	1993	1994	1995	1996	1997	1998
ASSETS:								
Cash	2	2	1	4	1	4	34	22
Accounts Receivable - Trade	486	839	926	1,193	1,329	1,977	2,110	2,107
Inventory								
Prepaid Expenses	45	62	47	80	81	104	3	10
Total Current	2,519	2,739	2,910	3,715	4,238	4,888	5,550	5,817
Fixed Assets								
Plant and Equipment	1,882	2,004	2,256	2,482	3,893	4,035	4,503	5,317
Land	480	480	480	480	1,005	1,005	1,005	1,005
Gross Fixed Assets	2,362	2,484	2,736	2,962	4,898	5,040	5,508	6,322
less: Accumulated Depreciation	851	1,058	1,284	1,528	1,880	2,239	2,638	3,074
Net Fixed Assets	1,511	1,426	1,452	1,434	3,018	2,801	2,870	3,248
TOTAL ASSETS	4,030	4,165	4,362	5,149	7,256	7,689	8,420	9,065
LIABILITIES								
Notes Payable - Bank	1,177	742	524	820	1,659	1,221	2,498	2,479
Current Maturities - Long Term Debt	0	0	0	0	95	90	121	91
Accounts Payable	342	784	1,066	1,342	905	1,767	1,053	1,171
Income Taxes Payable	0	1	0	70	49	47	45	44
Total Current	1,519	1,527	1,590	2,232	2,708	3,125	3,717	3,785
Long Term Debt	230	230	230	230	1,759	1,675	1,711	2,245
Deferred Income Taxes	68	45	41	15	6	7	4	0
Total Liabilities	1,817	1,802	1,861	2,477	4,473	4,807	5,432	6,030
Retained Earnings and Owners Equity	2,213	2,363	2,501	2,672	2,783	2,882	2,988	3,035
TOTAL LIABILITIES & EQUITY	4,030	4,165	4,362	5,149	7,256	7,689	8,420	9,065

Balance Sheet

- Report a company's assets, liabilities and equity at a **<u>specific point in time</u>**
- Three parts:
  - Assets shows what a company owns
    - Shows what helps generate the company cash
  - Liabilities show what a company owes
  - Equity shows the owner's claim on a company's assets
- **Assets = Liabilities + Owners Equity (ALOE)**
- **CASH IS KING**
  - Cash (and Marketable Securities) is the most accurate and objective account in any set of financial statements

Statement of Cash Flows

Cartwright Lumber Company Statement of Cash Flows For years ended December 31		
	2002	**2003**
Cash from Operations		
Net Income	$34	$44
Less: Increase in Accounts Receivable	$51	$95
Less: Increase in Inventory	$87	$92
Add: Increase in Accounts Payable	$68	$64
Add: Increase in Accrued Expenses	$6	$9
Net Cash from Opreations	($30)	($70)
Cash from Investing		
Less: Increase in Property Plant and Equipment (PP&E)	$14	$17
Net Cash from Investing	($14)	($17)
Cash from Financing		
Less: Current Debt Repayable	$7	$7
Add: Increase in Bank Note Payable	$146	$87
Less: Dividends Paid	$105	$0
Net Cash from Investing	$34	$80
Net Cash Flow	($10)	($7)
Beginning Cash	$58	$48
Ending Cash	$48	$41

Statement of Cash Flows

- If you could only choose two of the three financial statements to look at, which would you choose?

- Statement of Cash Flows gives insight into a company's quality of earnings
  - Credit sales do not always necessarily translate into cash
- Also shows the amount a business needs to invest in order to maintain level of income
  - High investment to generate minimal cash flows is not a good business

Cash Flow from Operations:
Net Income
+/- Non Cash Items
+/- Change in Working Capital

Cash Flow from Investing:
Capital Expenditures
Acquisitions

Cash Flow from Financing:
Debt Repayments/ Financings
Stock Repurchase/ Issuances
Dividends

Change in Cash

Financial Statement Relationships

- The three financial statements are interrelated, try to figure out the example below:
- Ex. What is the effect of $100 increase in Depreciation on the three financial statements?
  - Assume tax rate of 40%
- First, start with Income Statement
  - Revenue is unchanged
  - Operating Expenses increase by $100
    - Operating Income decreases by $100
  - Tax decreases by $40
  - Net Income decreases by $60

Financial Statement Relationships

- Next, go to the Statement of Cash Flows
  - Net Income decreases by $60
  - Depreciation and Amortization (D&A) increases by $100
  - Taxes payable decreases by $40
  - Cash is unchanged

- Lastly, go to the Balance Sheet
  - Assets
    - Accumulated Depreciation increases by $100
    - Net Assets decrease by $100
  - Liabilities
    - Taxes Payable decreases by $40
  - Equity
    - Retained Earnings decreases by $60
- **The fundamental equation holds: Assets = Liabilities + Equity**

Financial Ratios

SECTION II

Liquidity Ratios

- What is liquidity?
  - Ability to meet short term obligations

- Key ratios:
  - Current Ratio = Current Assets / Current Liabilities
  - Quick Ratio (Acid Test) = (Cash + Receivables) / Current Liabilities
  - Inventory Turnover = Cost of Goods Sold (COGS) / Average Inventory
  - Receivable Turnover = Net Credit Sales / Average Accounts Receivable
  - Payable Turnover = COGS / Average Accounts Payable

Profitability Ratios

- What is profitability?
  - How much of the revenue is translated into economic benefit

- Key ratios:
  - Gross Profit Margin= Gross Profit / Sales
  - EBITDA Margin = EBITDA / Sales
  - Operating Profit Margin= Operating Profit/ Sales
  - Profit Margin= Net Income / Sales

Asset Management Ratios

- What is asset management?
  - Measurement of how well a company is utilizing it's assets to generate profit

- Key ratios:
  - Total Asset Turnover = Net Sales / Average Assets
  - Fixed Asset Turnover = Net Sales / Net Fixed Asset
  - Return on Asset = Net Income / Total Assets
  - **Return on Equity = Net Income / Equity**
  - Return on Capital = (Net Income + Interest) / (Debt + Equity)

Debt Management Ratios

- Why are debt management ratios important?
  - For two reasons:
    1. Every company has an optimal capital structure; debt management ratios are a way to compare a company to its peers in the industry
    2. To measure the ability of a company to meet it's interest obligations

- Key ratios:
  - EBITDA Coverage = EBITDA/ Interest Expense
  - Interest Coverage = EBIT/ Interest Expense
  - Debt to EBITDA = Total Debt / EBITDA
  - Net Debt to EBITDA = Total Debt - Cash (Net Debt) / EBITDA
  - Debt to Assets = Total Debt / Total Assets
  - Debt to Equity = Debt / Equity
  - Debt to Capitalization = Debt / Capitalization (Debt + Equity)

Fun with Return on Equity (ROE)

SECTION III

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Fun with Return on Equity (ROE)

- The seemingly innocent ratio of ROE is actually a powerful proxy of a company's profitability
  - Extended Dupont Formula:

$$\left(\frac{\text{EBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} - \frac{\text{Interest}}{\text{Assets}} \right) \times \frac{\text{Assets}}{\text{Equity}} \times (1\text{-Tax Rate})$$

Operating Profit Margin	Asset Turnover	Interest Expense Rate	Financial Leverage	Tax Retention

Questions?

SECTION IV

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