CMF MSU

Financial Analysis: Company balance sheet

24 October 2015

Balance sheet & Financial accounts

What does it show?

Income statement	This measures the business' performance over a given period of time, usually one year. It compares the income of the business against the cost of goods or services and expenses incurred in earning that revenue
Balance sheet	This is a snapshot of the business' assets (what it owns or is owed) and its liabilities (what it owes) on a particular day - usually the last day of the financial year
Cash flow statement	This shows how the business has generated and disposed of cash and liquid funds during the period under review

Balance sheet

This is **a snapshot** of the business' assets (what it owns or is owed) and its liabilities (what it owes) on a particular day - usually the last day of a financial period

- What an entity owns (or controls)
- What it owes, and
- What the owners' claims are

Assets = **Liability** + **Equity**

Balance sheet example

($ thousands)	2013	2014	2015
ASSETS			
Cash, cash equivalents, marketable securities	1,900	200	3,300
Accounts receivable	500	1,050	1,500
Inventory	100	950	300
Total current assets	*2,500*	*2,200*	*5,100*
Property, plant, and equipment, net	750	750	4,650
Goodwill	0	300	0
Total assets	*3,250*	*3,250*	*9,750*
LIABILITIES AND EQUITY			
Accounts payable	0	2,500	600
Total current liabilities	*0*	*2,500*	*600*
Long-term bonds payable	10	10	9,000
Total liabilities	*10*	*2,510*	*9,600*
Total shareholders’ equity	3,240	740	150
Total liabilities and shareholders’ equity	**3,250**	**3,250**	**9,750**

Why does the balance sheet “balance”?

Because EVERY financial transaction results in an **equal change** in assets or liabilities

The concept of **“double-entry”**

Examples of “double-entry”

Transaction	Change in Assets	Change in Liabilities/Equity
Stocks bought from supplier on credit worth £5,000	Stocks up £5,000	Trade creditors up £5,000
Machinery bought for £100,000 in cash	Non-current assets up £100,000 Cash down by £100,000	No change
Cash sales of £10,000	Cash up £10,000	Profit up £10,000

Non-current assets

Boston Learning Systems plc Balance Sheet at 31 December	2009 £'000	2008 £'000
ASSETS		
Non-current assets		
Goodwill and other intangible assets	150	150
Property, plant & equipment	2,450	2,100
	2,600	2,250

Property, plant & equipment

Non-current assets

- Assets the business intends to keep
- Reflects the cost of capital expenditure
- E.g. machinery bought for £100,000
  - Is shown as a non-current asset in the balance sheet
  - Not treated as a cost in the income statement
- Depreciation
  - Allowance for the wearing out of a non-current asset over time
  - Treated as the cost of fixed assets wearing out

Non-current assets can be depreciated (amortized)

Original Cost of Asset

Depreciable Value

Salvage Value

Depreciation – illustrated

Straight-line method

$$depreciation\ in\ x\ year = \frac{original\ cost - salvage\ value}{depreciable\ life}$$

	Depreciation charge	Net book value
Bought	**0**	**100,000**
Depreciation (Year 1)	25,000	75,000
Depreciation (Year 2)	25,000	50,000
Depreciation (Year 3)	25,000	25,000
Depreciation (Year 4)	25,000	0

Original cost (Historical cost)

$$depreciation\ (Year\ 1) = \frac{100{,}000 - 0}{4} = 25{,}000$$

Depreciation – illustrated

Double-declining balance (1st approach)

$$depreciation\ expense = \frac{2}{\left(\begin{matrix} depreciable \\ life\ in\ years \end{matrix}\right)} \cdot \left(\begin{matrix} book\ value\ at \\ beggining\ of\ year\ x \end{matrix}\right)$$

	Depreciation charge	Net book value
Bought	**0**	**100,000**
Depreciation (Year 1)	50,000	50,000
Depreciation (Year 2)	25,000	25,000
Depreciation (Year 3)	12,500	12,500
Depreciation (Year 4)	12,500	0

Book value at beginning of Year 2

In last year is used straight-line method

Depreciation – illustrated

Double-declining balance (2nd approach)

$$depreciation = \frac{original\ cost - salvage\ value}{life\ in\ output\ units} \cdot \begin{pmatrix} output\ units \\ in\ the\ period \end{pmatrix}$$

	Output units	Depreciation charge	Net book value
Bought		**0**	**100,000**
Depreciation (Year 1)	250,000	41,667	58,333
Depreciation (Year 2)	200,000	33,333	25,000
Depreciation (Year 3)	100,000	16,667	8,333
Depreciation (Year 4)	50,000	8,333	0
Total	**600,000**		

$$depreciation\ (Year\ 1) = \frac{100{,}000 - 0}{600{,}000} \cdot (250{,}000) = 41{,}667$$

Intangible assets and Goodwill

Non-current assets

Only the "intangible" assets that have **actually been bought** can be included in the balance sheet

Goodwill:

- Arises when a company acquires another company for a price in excess of fair market value of net identifiable assets acquired
- Is equal to purchase price of business minus fair market value of net assets acquired
- Represents value of all favorable attributes that relate to a business enterprise
- Is recorded only when there is an exchange transaction that involves the purchase of an entire business
- Not amortized, but must be assessed for impairment

Current assets

Current assets		
Inventories	1,325	1,475
Trade and other receivables	4,030	3,800
Short-term investments	250	190
Cash and cash equivalents	1,340	780
	6,945	**6,245**

What are current assets?

Assets a business owns which are either **cash, cash equivalents**, or are expected to be turned into cash during the next twelve months or one operating cycle of the business, whichever is greater, after the reporting period

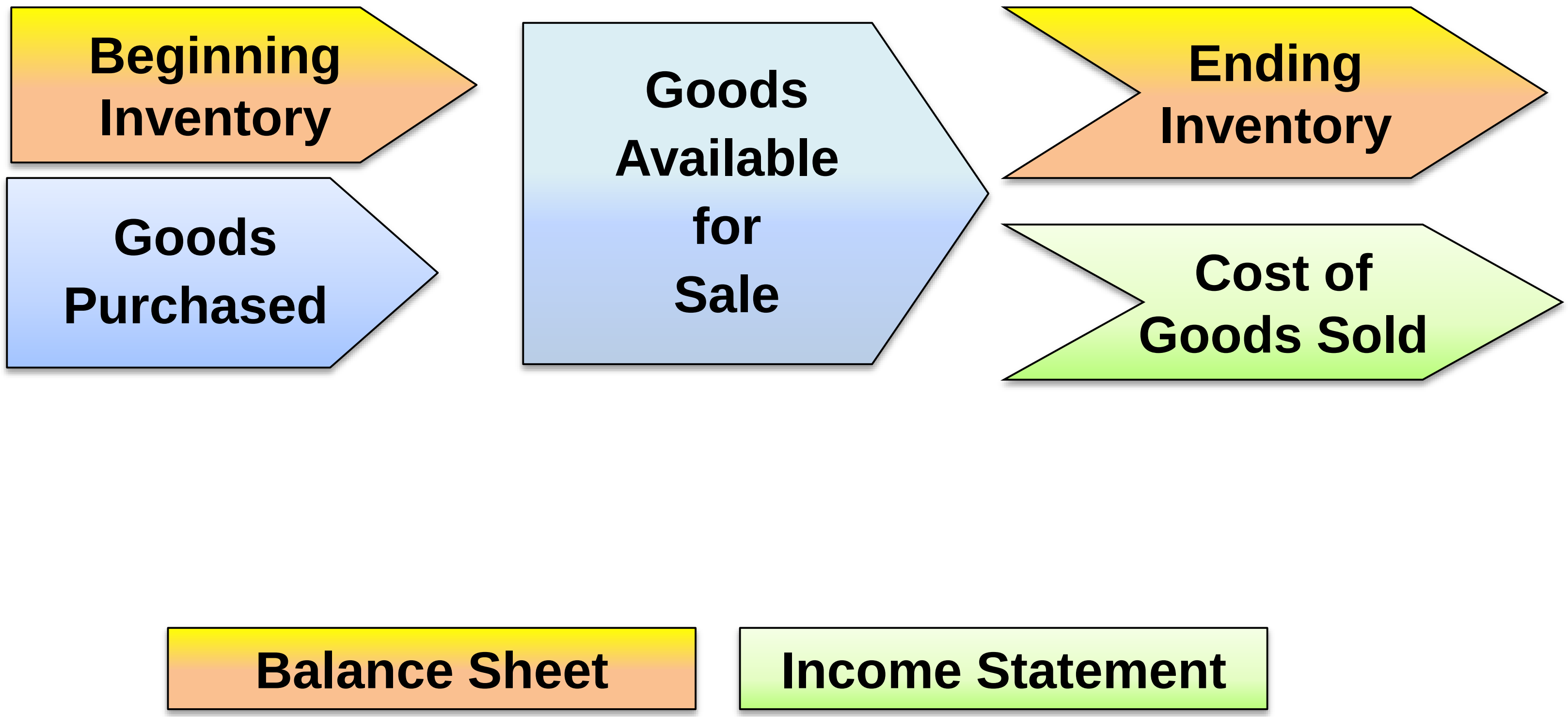
Inventories (stocks)

Current assets

- The least liquid kind of current asset
- Valued at the cost they were bought (not their selling price)
- Stock obsolescence – value should reflect what could be recovered

Measurement basis of current assets: Inventory

Inventory Cost Flow



Trade receivables

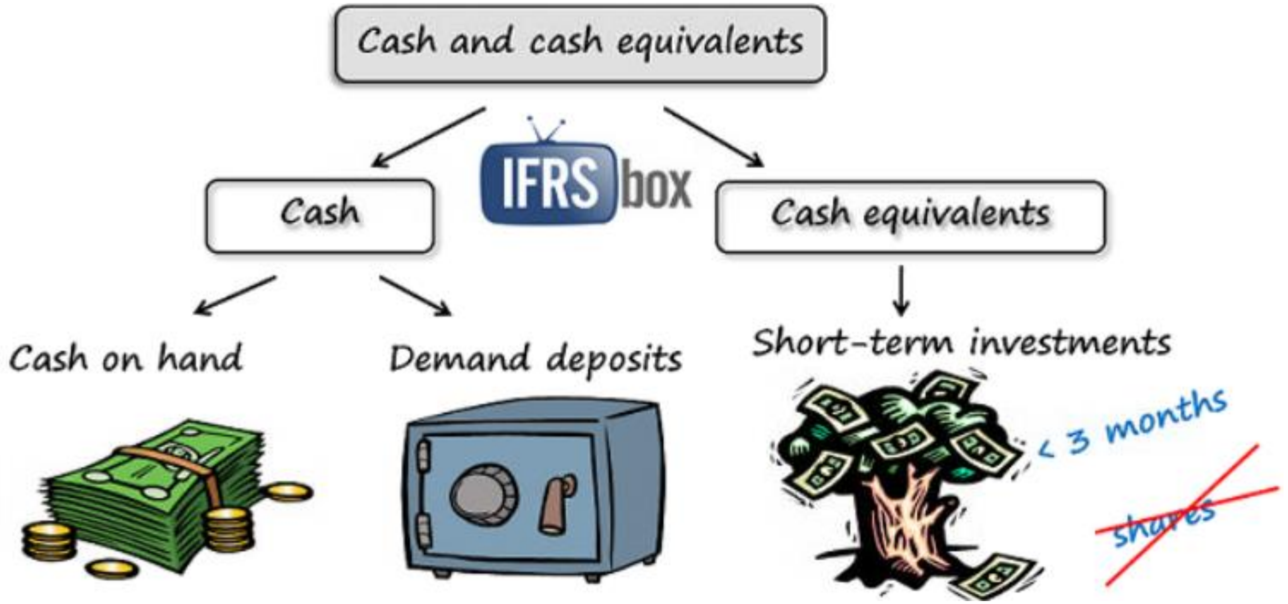
Current assets

- Normally known as trade debtors
- Amounts owed by customers buying on credit
- Late payment is a common and increasing problem
- Provision should be made for debtors not expected to pay

Cash and cash equivalents

Current assets

- The most liquid current asset!
- Balance sheet shows cash held at period-end



Current liabilities

Current liabilities		
Trade and other payables	2,310	2,225
Short-term borrowings	350	550
Current tax liabilities	800	650
Provisions **(short-term)**	290	255
	3,750	**3,680**

Trade and other payables

Current liabilities

- Trade payables – amounts owed to suppliers

- Important to take all the supplier credit available

- Worth comparing level of trade payables with trade receivables

Short-term borrowings

Current liabilities

- Includes balance on bank overdraft
- Shows the proportion of loans and other borrowings that have to be repaid in next 12 months
- Remaining amounts owed are shown in non-current liabilities

Current tax liabilities

Current liabilities

- Shows amounts owed in tax to government
- Corporation tax = estimate of tax owed on profit for the period
- Income tax and VAT = balance owed at end of month or quarter

Short-term provisions

Current liabilities

- Where a business make allowance for future costs and liabilities
- Based on the accounting concept of “prudence”
- Examples:
  - Potential costs of legal or customer disputes
  - Costs of reorganisation to which business is committed

Non-current liabilities

Non-current liabilities		
Borrowings	1,200	1,450
Provisions **(long-term)**	140	140
	1,340	**1,590**

Non-current liabilities

- **Long-term financial liabilities:** Include loans (i.e., borrowings from banks) and notes or bonds payable (i.e., fixed-income securities issued to investors)
    - Usually reported at amortized cost on the balance sheet.
    - In certain cases, liabilities, such as bonds, issued by a company are reported at fair value.

- **Deferred tax liabilities**: Amount of income taxes payable in future periods with respect of taxable temporary differences
    - Result from temporary timing differences between a company's income as reported for tax purposes (taxable income) and income as reported for financial statement purposes (reported income).

Equity

EQUITY		
Share capital	500	500
Retained earnings	3,955	2,725
TOTAL EQUITY	**4,455**	**3,225**

Equity

Two major components

- Shareholder's capital
  - Cash raised by the business from the sale of new shares (at amount originally sold) – common stock or share capital
  - Preferred shares
  - Accumulated other comprehensive income (or other reserves, items recognized directly in equity)
  - Non-controlling interest (or minority interest)
  - Does not reflect any change in value of share price
- Retained earnings
  - Net profits which have not been distributed to shareholders

SUMMARY

- Balance Sheet: what an entity owns (or controls), what it owes, and what the owners' claims are at a specific point in time

- Balance sheets usually present current and non-current assets and liabilities