ACCT7106 – Session #5: Understanding the Financial Statements

PART 1 – Background

assumed objective of management = ***maximize shareholders' wealth***

⇒ ***maximize share price!***

roles / functions management ... **ite -**

1. **Controller function** ⇒ asset efficiency (effi ... working capital)

2. **Treasury function** ⇒ long-term funds acq ... t or equity?)
3. **Capital budgeting** ⇒ real (productive) asset acquisition (fixed productive assets)

⇒ the fundamental decisions that ultimately determine the firm's profitability and its operating risk

⇒ the '***Value Drivers***'

Our objective – an understanding of how the firm (management) generates value

purpose – development of the pro-forma Financial Statements

Balance Sheet (B/S)

$\Rightarrow$ ***projected*** Income Statement (I/S)

over the forecast horizon Statement of Cash Flows (SCF)

➡ core inputs into the valuati *x* *g*

$$V_0 = \sum_{t=1}^{\infty} \frac{x_t}{(1+k_t)^t} = \sum_{t=1}^{n} \frac{E(x_t)}{(1+k)^t} + \frac{E(x_n)(1+g)}{k-g} \frac{1}{(1+k)^n}$$

Stages of the Analysis

Stage 1 – Understanding the Business

→ **‘Strategy Analysis’**

- product market
- competition
- regulatory constraints
- business strategies
- technology

Stage 2 – Analysing Information

Accounting Analysis & Financial Analysis

- quality of accounting information
- reformulating the F/S to uncover business activities
- ratio and cash flow analysis

Stage 3 – Prospective Analysis: Forecasting

⇨ *pro-forma*
- Income Statement
- Balance Sheet
- Statement of Cash Flows

Stage 4 – Prospective Analysis: Valuation

- Abnormal Earnings Model
- Alternative Valuation Models

tatement of Cash Flows

Stage 5 – Prospective Analysis: Application

→ investment decision

investor – decision to buy, hold, sell

manager – decision to adopt strategy or not

e.g., proforma Income Statement

	2019	2020	2021E	2022E	2023E
Sales	**38,176**	**37,408**	**± ? %**	**± ? %**	**± ? %**
Other operating revenue	288	376			
Cost of sales	**(29,253)**	**(28,043)**	**± ? %**	**± ? %**	**± ? %**
Other income	428	108			
Administrative expenses			**± ? %**	**± ? %**	**± ? %**
Other expenses	(146)	--			
Share – equity investments	5	([illegible]			
Financing costs	**(42)**	**(443)**	**± ? %**	**± ? %**	**± ? %**
Income tax expense	**(347)**	**(341)**	**± ? %**	**± ? %**	**± ? %**

caution – for 'clean surplus' and consistent estimates, the accounting system must reconcile

⇨ must concurrently develop the proforma Balance Sheets and Statement of Cash Flows

⇒ **‘tool box’** i.e.,

- ✓ external factors → economic climate (cycle), macroeconomic factors, political/regulatory, socio-cultural
- ✓ industry structure and dynamics → suppliers, buyers, new entrants, substitutes, rivalry
- ✓ competitive strategy → cost leader, differentiation, first mover

****

Now seek to add an understandi ***‘financial performance’*** to the ‘tool box’ by analysing the Finan

why? insights into (among other factors), o icies, production technologies and techniques, inventory and credi

operating decisions ⟷ financial performance

Step #1 – the Financial Statements as presented ~ Session #5

Step #2 – reformulation of the Financial Statements

Step #3 – assessment of ‘accounting quality’ ~ Sessions #6, 7, 8

Step #4 – analysis ≡ ratios

➢ Reporting Obligations of Australian Publicly Listed Companies

Legally, publicly-listed Australian companies are public and 'disclosing entities' under the Corporations Act (2001)

⇒ they must provide:

- an annual financial report that includes financial statements, notes to the financial statements, and a directo

- the financial report must comply with Aus unting Standards (AASB standards) and must be audited

- the directors' report provides a summary across a broad range of aspects relating to the firm and its operations
- a half-year report that has similar requirements, but usually does not provide as much detail, and might be reviewed rather than audited

- Listed companies must also comply with ‘continuous disclosure’ requirements

  → they must immediately disclose information that might materially affect their share price through the Australian Stock Exchange (ASX) website

  (in the US, this is done through the Securities Exchange Commission (SEC) website instead)

- Information disclosed on the ASX website are called company ‘announcements’
  - https://www.asx.com.au ents.do
  - includes annual/half year
  - news released under continuous disclosu
  - insider trading reports
  - significant ownership reports

➢ Accounting Standards (AASB)

- Australian companies must comply with Australian Accounting Standards Board pronouncements (AASB standards)
- these are a local variant of International Financial Reporting Standards (IFRS)
- IFRS standards are used in most countries, usually with minor local tweaks

- the US uses its own standard ot based on IFRS. However, IFRS and US GAAP are very similar

→ the ‘tools’ developed in this course can be used broadly in any jurisdiction

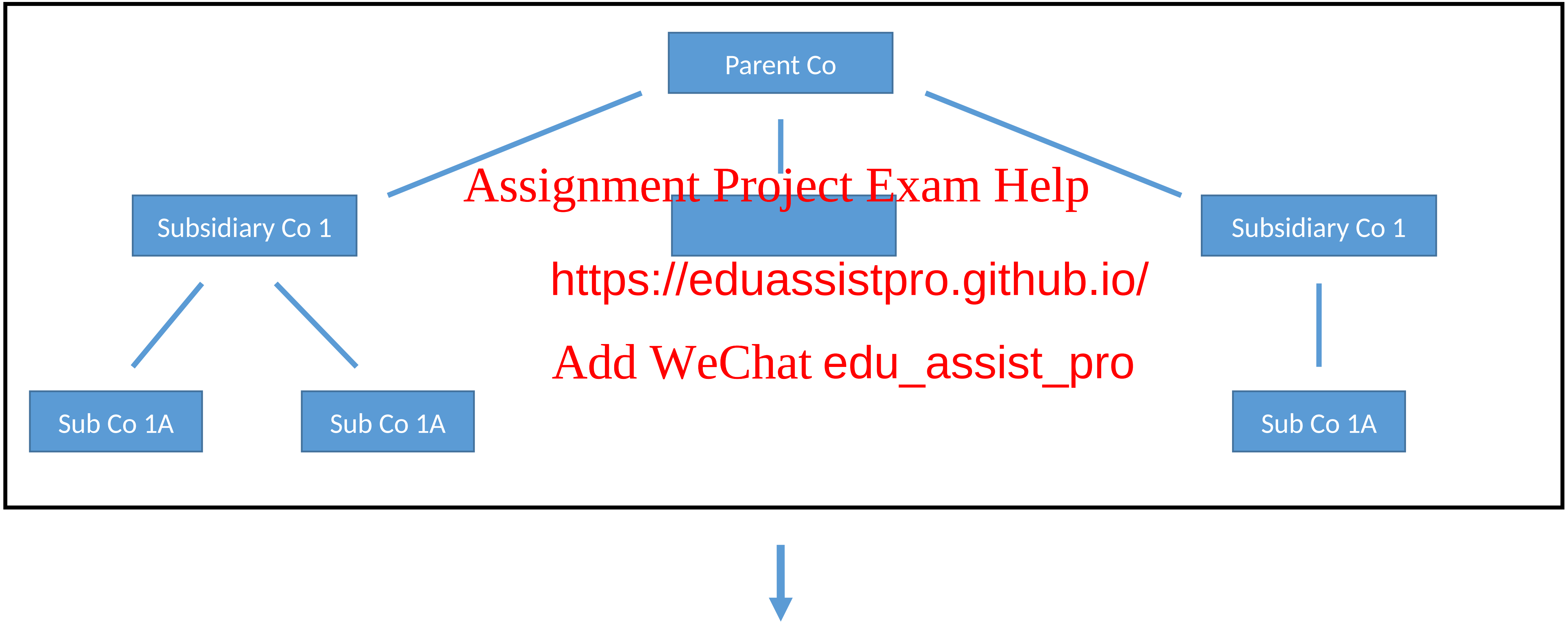
➢ Financial Statements

- AASB 101 requires five things:
  - Balance Sheet (or Statement of Financial Position)
  - Income Statement (or Statement of Profit & Loss) *and/or* Statement of Comprehensive Income
  - Statement of Changes in Equity
  - Statement of Cash Flows
  - Notes to the financial stat

- Comprehensive Income can be reported in t ways:
  - prepare a Statement of Comprehensive Income separate from the Income Statement, but immediately following it (*this is how Coles reports – pages 98/99*)
  - combine the two as one Statement of Profit/Loss and Comprehensive Income

- Financial Statements must show at least two-years of comparative numbers under AASB 101 (e.g. FY19 and FY20 in the 2020 Annual Report)

- the financial statements we will be using are **Consolidated**, meaning they represent the combined financial statements of the parent company and all the subsidiaries it controls



the ***consolidated entity*** produces <u>*one set of Financial Statements*</u>

Cautions –

- the financial statements are **general purpose**; they are prepared for a variety of stakeholders (shareholders, creditors, suppliers, customers, etc.)

- they are not set-out perfectly for shareholders and for doing valuation

  - need to 'reformulate' th[illegible]rder to make them more useful for fundamental analysis and valuation

    - separation of 'operating activities' and 'financing activities'

➢ Directors' Report

- Australian companies must provide a Directors' Report in their Annual Report
  - usually placed towards the start of the Annual Report
  - similar the 'Management Discussion & Analysis' (MD&A) provided by US firms

- the requirements for the Directors' Report are contain in the Corporations Act (2001, sections 299-300A) and Reg ued by ASIC (especially RG 247)

- the Directors' Report provides information derstanding how the company has performed, and some clues about how i orm in the future e.g.,
  - description of the company's operations and strategy
  - explanation of the current year's results
  - business strategies
  - risks
  - future outlook

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PART 2 – The Accounting Process:

(1) *Balance Sheet (B/S)*: position at a specific point in time measured in accordance with GAAP

(2) *Income Statement (I/S)*: summary of activities for period, part of bridge between two B/S

(3) *Statement of Cash Flo* s of cash

(4) *Notes to F/S*: supplementary informa isclosure

The **"building blocks"** of Financial Accounting (GA

1) *basic elements* - definitions specific to accounting

2) *qualitative characteristics* - characteristics necessary for the F/S to meet users' needs

3) *environmental assumptions* - structure of framework within which accounting must function

4) *accounting principles* - broad standards/guidelines (man-made based on "logic" not on natural law)

- ***Basic Elements*** → definitions specific to accounting

e.g., *asset* - future benefit

- controlled by the firm

on

liability - curren om a past transaction

- deter rity value and date
- payee identifiable
- cannot avoid future sacrifice (no offset)

'assets', 'liabilities', 'owners' equity', 'revenue', 'gain', 'expense', 'loss', 'earnings (net income)'

- ***Qualitative Characteristics*** $\rightarrow$ characteristics necessary for the F/S to meet users' needs

  1. relevance - makes a difference in decisions i.e., improves predictive ability, confirms expectations

  2. reliability - dependability

  3. timeliness - information available before it loses capacity to influence decisions

  4. verifiability

  5. neutrality

  6. comparability - improves both reliability and relevance

  7. consistency - select the same method each year

  8. uniformity - same method used by all firms

➢ ***Environmental Assumptions***

→ provide structure of framework within which accounting functions

1. economic (separate) entity assumption - each enterprise is considered as an accounting unit separate and apart from the owners and other entities irrespective of legal status

e.g., proprietorship: unlimited liability BUT keep books of "store" separately!

2. periodicity assumption - hort-term, periodic F/S even though the results can not be know specifically u n

3. *continuity assumption* - in absence of evidence to the contrary, the business entity is assumed to remain in operation long enough to carry out its contemplated operations, contracts, and commitments

4. monetary unit assumption - money is the best common denominator since it is "relevant, simple, available, understood, and useful" (also states that fluctuations in the value of the dollar can be ignored without impairing usefulness)

➢ *Accounting Principles*

- rules giving guidance to measurement, classification, and interpretation of economic information

- broad standards or guidelines (are man-made based on "logic" not on natural law)

The next set of slides (#18 - #24) presents an illustration of the mechanics of accounting for a small retail organisation, and thereby the development of its Financial Statements

***** this material is illustrative only; it is not eligible for examination *****

Example #5-1

In late 20X0, CM and MC decided to open a sporting goods wholesale operation, CMMC Ltd. The firm's balance sheet as at 31 December 31, 20X0 consisted of only two items, cash of $1,000,000 and contributed capital of $1,000,000. Information concerning the firm and its activities during 20X1 follows:

1. On January 1, 20X1, CMMC purchased land and a building for $500,000, paying $300,000 in cash and financing the remainder with a new $200,000 10-year 12% bond issue. The fair market value of the land at that date was $300,000. The building had an estimated life of 20 years and has no expected scrap value.
2. Because of its relative immaturity, CMMC decided to focus its attention on the distribution of only one item, sailboards. The following purchases were made on credit during 20X1:

   2 January: *35* *400 units @ $300 each*

   CMMC still owed suppliers $

3. Sales for the year were $350,000 (700 u t, only $85,000 remained uncollected at year-end. CMMC decided to use the FIFO method of inventory val n the experiences of similar firms, CMMC believes that 1.5% of the outstanding receivables will ultima tible.

4. CMMC paid $4,000 for a two-year insurance policy on July 1, 20X1.
5. Administrative, selling, and general expenses (other than interest, depreciation, and labour) were $31,000 for the year. All of these expenses had been paid by the end of the year.
6. Labour wages for 20X1 were to $45,000. Of this amount, only wages from the last half of December remain unpaid (assume wages are earned uniformly throughout the year).
7. CMMC declared a dividend of $30,000 on December 31, 20X1, to be paid on January 10, 20X2.
8. The firm's tax rate is 43%

'Mechanics' –

***Step #1*: Journal Entries**

→ identifies each event and amount in the journals

***Step #2*: t-accounts**

→ summarises each event and amount by account, and produces final balances

***Step #3*: Financial Statements**

→ structured presentation of the final balances from the t-accounts

Journal Entries:

1.	DR land	300,000	
	DR building	200,000	
	CR cash		300,000
	CR B/P		200,000

DR int exp	24,000	
CR cash		24,000
DR amort exp	10,000	
CR acc amort		10,000

Prepaid Insurance

4,000	1,000
3,000	

Land

300,000	
300,000	

Building

200,000	
200,000	

Accumulated Depreciation

	10,000
	10,000

Assets

Liabilities

Common Shares

	1,000,000
	1,000,000

Retained Earnings

30,000	35,753
	5,753

Shareholders' equity

CMMC Ltd.

Income Statement for the year ended December 31, 20X1

Sales
350,000
COGS
(175,000)
Gross Profit
175,000
Operating Expens
depreciation
bad debt expense
insurance 1,000
administrative 31,000
labour expense 45,000
(88,275)

Operating Income 86,725

Financing costs (interest expense) (24,000)

NIBT 62,725

CMMC Ltd.

Balance Sheet, December 31, 20X1

cash

700,903

accounts receivable 85,000

allowance <u>(1,275)</u>

83,725

inventory

15,000

prepaid insuranc

3,000

land 300,000

building 200,000

acc dep^n <u>(10,000)</u>

-

<u>190,000</u>

Total Assets

<u>1,292,628</u>

accounts payable 55,000

wages payable

CMMC Ltd.

Statement of Cash Flows for the year ended December 31, 20X5

Operations:			
	Cash receipts	265,000	
	purchases	(135,000)	
	insurance	(4,000)	
	G,S & A expenses	(31,000)	
	labour	(43,125)	
	interest	,000)	
	taxes	,972)	903
Investing:			
	purchase of land	(300,000)	
	purchase of building	(200,000)	(500,000)
Financing:			
	bonds payable	200,000	
	dividends	(0)	200,000
Net Decrease in Cash			**(299,097)**

PART 3 – The Financial Statements

1. Balance Sheet (Statement of Financial Position:

- presents the company's financial position as at a particular point in time (end of the reporting period)

- classifications: Assets, Liabili

- Assets and Liabilities further classified into:
  current (realised within 12 months)
  non-current (economic value to firm > 12 months)

- Accounting relation: Total Assets = Total Liabilities + Common Shareholders' Equity

Companies must show *at least* the following items on the *face* of the Balance Sheet (assuming the item exists for the company) (AASB 101):

- Assets:
  - Property, plant and equipment (PPE)
  - Investment property
  - Intangible assets
  - Financial assets
  - Investment accounted for u equity method
  - Inventories
  - Trade and other receivables
  - Cash & cash equivalents
  - Assets held for sale as part of discontinued operations
  - Deferred tax assets

- Liabilities:
  - Trades and other payables
  - Provisions
  - Financial liabilities
  - Income tax payable
  - ferred tax liabilities
  - ities associated with discontinued tions
- Equity:
  - Non-controlling interests (NCI)
  - Issued capital
  - Reserves

Total Assets = Total Liabilities + Shareholders' Equity

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2. Income Statement (‘Statement of Financial Performance’ or ‘Profit and Loss Statement’)

- shows financial performance over a period of time (usually 12 months)
- the core aspect of the I/S typically has the following basic structure:

Revenue
- Cost of goods sold (COGS)

= Gross margin (or gross profit)

- Operating exp rtising, R&D)

= Earnings before inter ortisation (EBITDA)

- Depreciation and amortisation

= Earnings before interest and tax (EBIT)

- Net interest expense (or net of interest revenue)

= Profit before tax (PBT)
- Income tax expense

= Net profit after tax (NPAT) (but before extraordinary items)

± extraordinary items

= Net Income
- Preferred dividends

= Net Income to Common Shareholders

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3. Statement of Changes in Shareholders’ Equity

- provides a detailed break-down of changes in equity accounts over the period
- Shareholders’ Equity typically consists of up to five accounts:
  - **Contributed capital**: how much shareholders have historically invested in the company
  - **Treasury stock**: cost of shares repurchased (but not retired)
  - **Retained earnings**: (basica [illegible] s past dividends
  - **Non-controlling interest (** [illegible] of controlled subsidiaries not owned by the parent company
  - **Reserves**: used for various items that affect equity, but do not pass into retained earnings (typically these items go through Other Comprehensive Income) e.g.,
    - if PPE is revalued upwards to fair value, the increment is placed in a Revaluation Reserve (AASB 116)
    - most companies place share-based payments in a reserve until the share-based payments (typically options) are exercised/expire (AASB 2)
    - translation of foreign operations into the company’s presentation currency (AASB 121)

changes in equity accounts can be classified into two categories:

Comprehensive income (CI):

=NPAT

+OCI

Net transactions with shareholders:

= Cash dividends

+ Share repurchases (trea

- Shares issued (dividend reinvestment plans, issu or NCI, treasury shares issued, etc.)

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4. Statement of Cash Flows

- sources and uses of cash over a period of time (usually 12 months)
- similar to the Income Statement, but based on cash accounting, rather than accrual accounting
- structure:
  - cash flow from operations (CFO):
  - cash flow from investin
  - cash flow from financin

- CFO can be presented in two different ways :
  - *Direct method*: itemised cash receipts le ments related to operations
  - *Indirect method*: profit +/- non-cash items and net changes in working capital
- the direct method was historically required in Australia and is still the most common
- the indirect method can be used in Australia and is very common in other countries
- in Australia, if the direct method is used, the indirect method must be shown in the notes

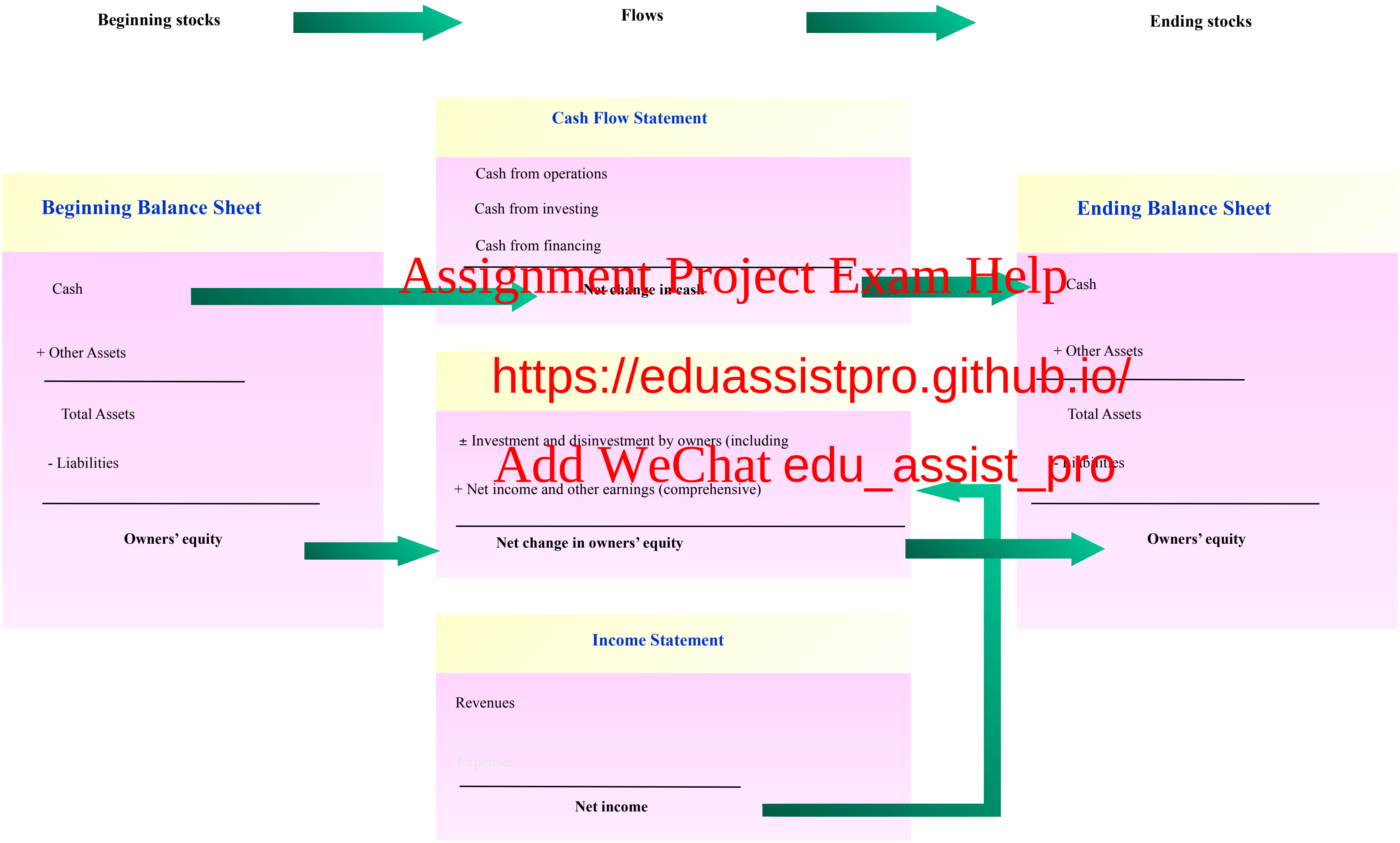
indirect method
from Footnote 2.1

5. Notes to the Financial Statements (pages 103 – 148 of Coles 2020 Annual Report)

- usually appear at the end of the financial report after the financial statements
- typically provide details of the following:
  - description of accounting policies
  - details of segments
  - finer detail on financial st
  - miscellaneous disclosures n law, such as list of subsidiaries, shareholder statistics, major shareholder

The details provided in the 'Notes' are an imperative for fully understanding the information conveyed by the Financial Statements (I/S, B/S, and SCF)

The Articulation of the Financial Statements (Figure 2.1, page 42)



PART 4 – Comprehensive income (CI) (and 'dirty' versus 'clean' surplus)

The ***'clean surplus'*** relation is the standard accounting identity

Ending book value (shareholders' equity)

= beginning book value + income – dividends ± changes in contributed capital

$$BV_t = BV_{t-1} + E_t - D_t \pm N$$

The key within this equation is that income (E) is in fact 'comprehensive income' (CI) and not 'net profit after tax' (NPAT or OI)

consider Coles again

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Statement of Changes in Equity

Accounting adjustment

BV_{t-1}

Comprehensive Income

NCC

Dividends

BV_t

Comprehensive Income (CI)

- basically a more complete measure of performance than ‘net profit after tax’ (NPAT)
- CI = NPAT + **Other Comprehensive Income** (OCI)
- OCI is also called ‘dirty surplus’ – it is termed ‘dirty’ because it is not counted towards NPAT (*note* – surplus is an ‘old’ name for profit)

- CI satisfies an important rela s relation (CSR): (usually, net profit does not satisfy this relati

- a list of OCI items appears in AASB 101 (and is summarised following):

bottom line – basically a lot of messy, complicated things; the most common ones are FX translation gains/losses and cash flow hedging gains/losses

(a) changes in revaluation surplus (AASB 116 Property, Plant and Equipment and AASB 138 Intangible Assets);

(b) re-measurements of defined benefit plans (AASB 119 Employee Benefits);

(c) gains and losses arising from translating the financial statements of a foreign operation (AASB 121 The Effects of Changes in Foreign Exchange Rates);

(d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of AASB 9 Financial Instruments;

(da) gains and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of AASB 9.

(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that [illegible] struments measured at fair value through other comprehensive income in acc [illegible] of AASB 9 (Chapter 6 of AASB 9);

(f) for particular liabilities designated as at fair value thro [illegible] ss, the amount of the change in fair value that is attributable to changes in the liability's cr [illegible] raph 5.7.7 of AASB 9);

(g) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value (Chapter 6 of AASB 9); and

(h) changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (see Chapter 6 of AASB 9).

PART 5 – Accounting Concepts: Recognition and Disclosure

- ***Recognition*** → formally including an item in the financial statements
- ***Disclosure*** → merely disclosing the existence of an item in the Notes, but not formally including it in the financial statements

Example: contingent liabilities

"A possible obligation that arises istence will be confirmed only by the occurrence or non-occurrence of events not wholly within the control of the entity" (AASB 137)

e.g., a loan guarantee – will only become a liability er company defaults (or becomes likely to default)

→ does NOT currently meet the definition of a liability and hence can not be formally recognised (included) in the Balance Sheet (*see Slide #16 for definition of a liability*)

→ disclosed in the notes (see Coles 2020 Annual Report Note 6.2 on page 143)

Accounting Policies

- **Revenue Realization Principle:**
  - revenue is the creation of wealth
    - → any inflow other than from owners' equity or creditors, measured as net cash equivalent price from an arm's length transaction
  - in general, revenue is reco n an exchange transaction and the earnings process is ess
    - → sales basis (employed when colle in full is reasonably certain and when related expenses are determinable)

➢ Matching Principle:

- based on cause and effect i.e., all expenses incurred in generating revenue should be reported in the period when the revenue is recognized

definitions:

expenditure - decrease in asset or increase in liability associated with incurrence of a cost

expense – using up of resources by entity's tivities during current period

⇒ an expenditure may benefit the period in which it occurs and/or future periods (e.g., acquisition of fixed assets) whereas an expense is of benefit only to the period in which it is consumed

⇒ an item of cost must either be defined as an asset or as an expense

e.g., purchase inventory for resale - becomes cost of goods sold (COGS) on I/S only in period when sold else held on the B/S as an asset (inventory)

exceptions to the matching principle include

a) period expenses

- costs of doing business e.g., administrative costs, costs of accountant, etc.
- these costs are expensed in the period in which they are incurred

why? they don't have an obvious link to revenue of some future period

question - what about advertising exp mpact on future revenue BUT causal link is difficult to establis

⇒ are typically expensed in period when incurred

b) dividends

- dividends are not expenses from the accounting perspective

⇒ recorded directly to Retained Earnings (as a reduction) ***when declared***

Accounting Concepts: Accruals

Why accrual accounting?

- recognises revenues (expenses) when they are earned (incurred), rather than when the cash is received (paid)

- resulting earnings generally provides a better measure of economic value added than cash flow

  e.g., suppose a company mad m in credit sales for a year – looking only at cash sales would of the company's performance

- accruals accounting is better for forecasti ces smoother and more predictable earning

- accrual accounting simply changes the timing of when items are recognised in the F/S - over the life of the company, cash flows and revenues/expenses must be the same

- accruals involve some estimation (e.g., provision for doubtful debts) – this introduces the possibility of estimation errors

- the main measure of performance under accrual accounting is NPAT (or CI)
- the main measure under cash accounting is CFO
- total accruals = NPAT – CFO

From the Coles’ presentation in Footnote 2.1 of its CFO using the indirect method

Profit = 978

Accruals = 1,574 (adding up all the adjustme[illegible]ges in assets and liabilities)

CFO = 2,552

caution – determination of ‘accruals’ involves managerial discretion (e.g., estimates) and thereby can impact the quality of the accounting figures

PART 6 – Accounting Concepts: Measurement

- having decided to recognise an item in the Financial Statements, its value (amount) must then be measured –

- four main measurements methods used under AASB/IFRS (see Conceptual Framework):
  - **Historical Cost**: how much the item originally cost less (if applicable) accumulated depreciation/amortisatio cumulated impairments

  - **Fair Value** (or current cost t value – what would it cost today to buy the asset or to repay the liability

  - **Realisable Value**: what could the asset be sold for today?
  - **Present Value**: present value of future cash flows related to the asset or liability

(*note* – typically, Realisable Value and Present Value are viewed as being the same as Fair value)

Cash and Cash Equivalents	Fair value (cash is cash)
Accounts Receivable, net of Provision for Doubtful Debts	Expected amount to be collected from receivables. This should be close to Fair value
Inventories	Lower of cost and net realisable value
Property, plant and equipment	Historical cost (most companies) depreciation and impairments
Intangibles	Can be istorical cost (most companies) or Fair value less amortisation and impairments
Goodwill	Historical cost (with impairments, but no amortisation)
Investment property	Fair value (typically) or Historical cost

Accounts payable	Historical cost, which is usually close to fair value
Borrowings	Amortised cost (usually); fair value is permitted, but not used often by industrial companies
Deferred revenue	to be earned in the future. This sho to fair value
Provisions, e.g., provision for warranty expenses	Present value of estimated future expenses. This should be close to fair value

Measurement – Equity Investments

For equity investments in another company, the accounting depends on whether the company has ‘control’, ‘significant influence’, or neither

- **Control** (usually >50% ownership):
  - the investee company is known as a ‘subsidiary’ and the owner is called the ‘parent’
  - consolidation method: basically add the subsidiary and parent’s accounts together – no separate asset for the investment is recognised

- **Significant influence** (usuall
  - the investee company is kn
  - equity method of accounting: recognise an ass heet; recognise share of profits/losses of associate; recognise dividends associate

- **Joint control** (usually 50% ownership):
  - the investee company is known as a ‘joint venture’
  - equity method of accounting is used

- **Neither** (usually < 20% ownership):
  - recognise an asset
  - measurement depends on management’s intention

For investments in debt securities (e.g. bonds) and minor investments in equity securities (<20% ownership), measurement depends on management's intentions with respect to the investment

❖ **Held to maturity** (debt only)

- management intends to hold the debt until it matures
- measurement is at amortised cost

❖ **Held for trading** (debt/equity)

- management intends profi
- measurement at fair value, n the Income Statement

❖ **Available for sale** (debt/equity)

- management's intention is not to hold to maturity or hold for trading
- measurement at fair value, with gains/losses recognised in OCI

(*note* – see updated AASB 9 for specific details)

Accounting Concepts: Classification

- once an item is recognised and measured, the final decision is how to classify the item
- typical issues:
  - is an item a liability or equity? (Balance Sheet)
  - is an item a recurring or non-recurring item (e.g. an extraordinary item)? (Income Statement)
  - is it an operating, investing or financing cash flow (e.g. interest paid)? (Cash Flow Statement)

- our interest is also in re-class

example: preference shares – financial instrume eatures of both equity and liabilities

equity: pay dividends; rank below debt in pay ds and repayment on liquidation

liability: typically dividends are fixed; rank above ordinary shares for dividends and repayments

⇒ difficult to classify in the Balance Sheet: are they liabilities or equity?

in practice, can be classified as liabilities, equity or split into both (depending on the exact terms of the preference share)

we will reclassify all preference shares as financial obligations

Accounting Concepts: Going Concern Assumption

- IFRS/AASB accounting is done on the basis that the company will continue to operate for the foreseeable future (it is a **going concern**) (continuity assumption, Slide #18)

  $\Rightarrow$ the business/company/venture is an ongoing, continuing business

- AASB 101:

  - management must assess going concern i.e., it is not likely to be liquidated or cease t

  ust disclose if there is uncertainty

  - if a going concern, normal accounting is us

  e company should disclose the accounting method (could be anything)

- auditors must check on management's going concern assessment (see ASA 570)

- for purposes of the valuation exercise, we typically assume the company is a going concern (there are special valuation techniques for companies that are not going concerns, for example asset-based valuation)

PART 7 – Summary: Sessions #1 → #5

overarching focus – fundamental value **('intrinsic value')**

➙ requires an understanding of the 'value drivers'

➡ need to accumulate a 'tool kit' as the basis for developing the *pro forma Financial Statements*

STEP 1
Understanding the past

1. Information collection
2. Understanding the business
3. Accounting analysis
4. Financial ratio analysis
5. Cash flow analysis

STEP 2
Forecasting the

1. Structured forecasting
2. Income Statement forecasts
3. Balance sheet forecasts
4. Cash flow forecasts

STEP 3
Valuation

1. Cost of capital
2. Valuation models – AE, FCF, D
3. Valuation ratios
4. Complications
   a. Negative values
   b. Value creation and destruction

Figure 1.1 Lundholm & Sloan, *Framework for Equity Valuation*

Stages of the Analysis

<u>Stage 1</u> – Understanding the Business

→ 'Strategy Analysis'

- product market
- competition
- regulatory constraints
- business strategies
- technology

<u>Stage 2</u> – Analysing Information

Accounting Analysis & Financial Analysis

- quality of accounting information
- reformulating the F/S to uncover business activities
- ratio and cash flow analysis

<u>Stage 3</u> – Prospective Analysis: Forecasting

⇨ *pro-forma* - Income Statement
- Balance Sheet
- Statement of Cash Flows

<u>Stage 4</u> – Prospective Analysis: Valuation

- Abnormal Earnings Model
- Alternative Valuation Models

tatement of Cash Flows

<u>Stage 5</u> – Prospective Analysis: Application

→ Investment decision

investor – decision to buy, hold, sell

manager – decision to adopt strategy or not

external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

Analysis of Financial Statements

- understanding current F/S
- re-formulating the F/S
- accounting quality

??

Industry dynamics
→ Porter's five forces
(suppliers, buyers, new entrants, substitutes, rivalry)

e.g., proforma Income Statement

	2019	2020	2021E	2022E	2023E
Sales	**38,176**	**37,408**	**± ? %**	**± ? %**	**± ? %**
Other operating revenue	288	376			
Cost of sales	**(29,253)**	**(28,043)**	**± ? %**	**± ? %**	**± ? %**
Other income	428	108			
Administrative expenses			**± ? %**	**± ? %**	**± ? %**
Other expenses	(146)	--			
Share – equity investments	5	[illegible]			
Financing costs	**(42)**	**(443)**	**± ? %**	**± ? %**	**± ? %**
Income tax expense	**(347)**	**(341)**	**± ? %**	**± ? %**	**± ? %**

caution – for 'clean surplus' and consistent estimates, the accounting system must reconcile

⇨ must concurrently develop the proforma Balance Sheets and Statement of Cash Flows