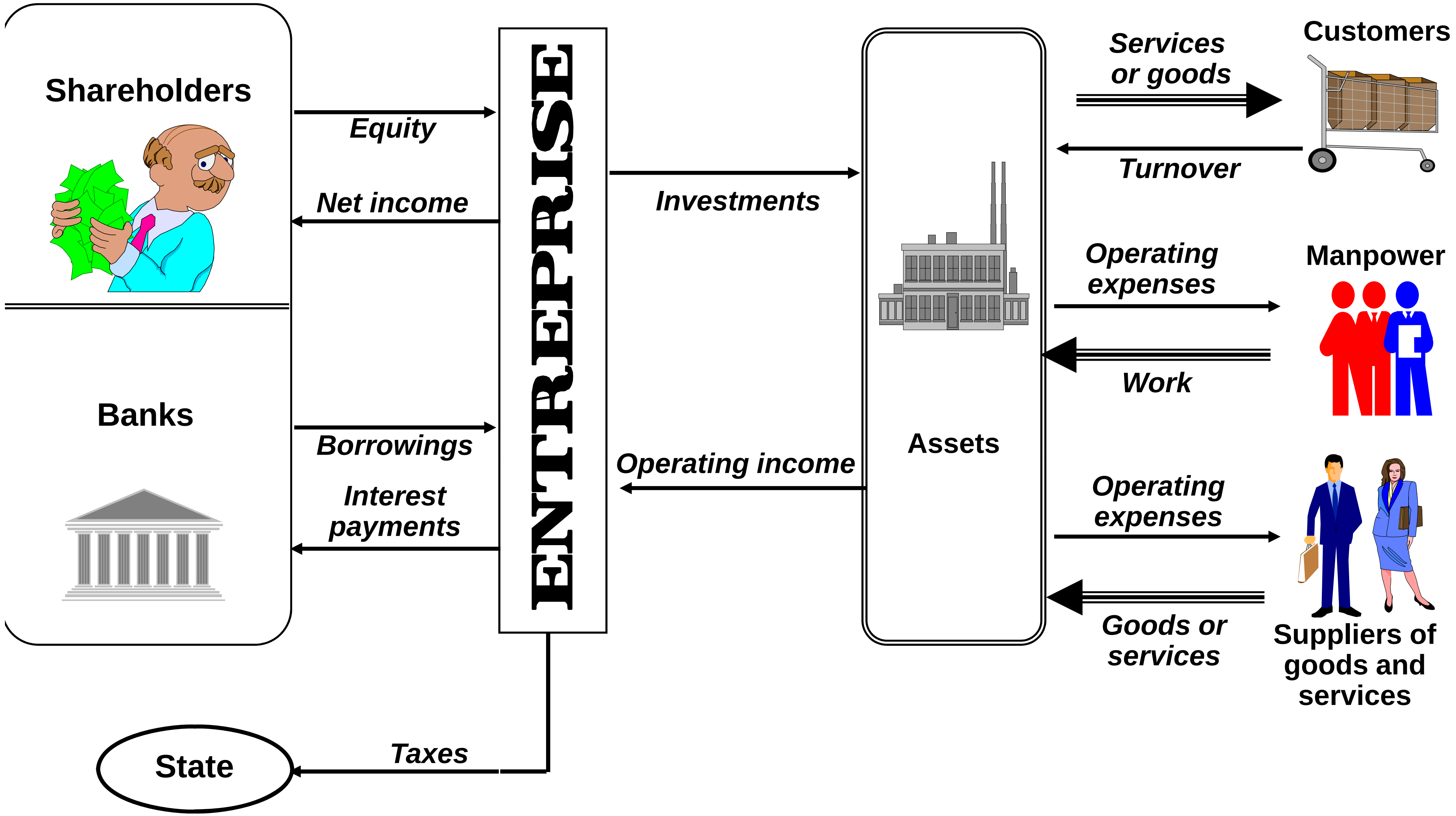
Introduction to financial reporting

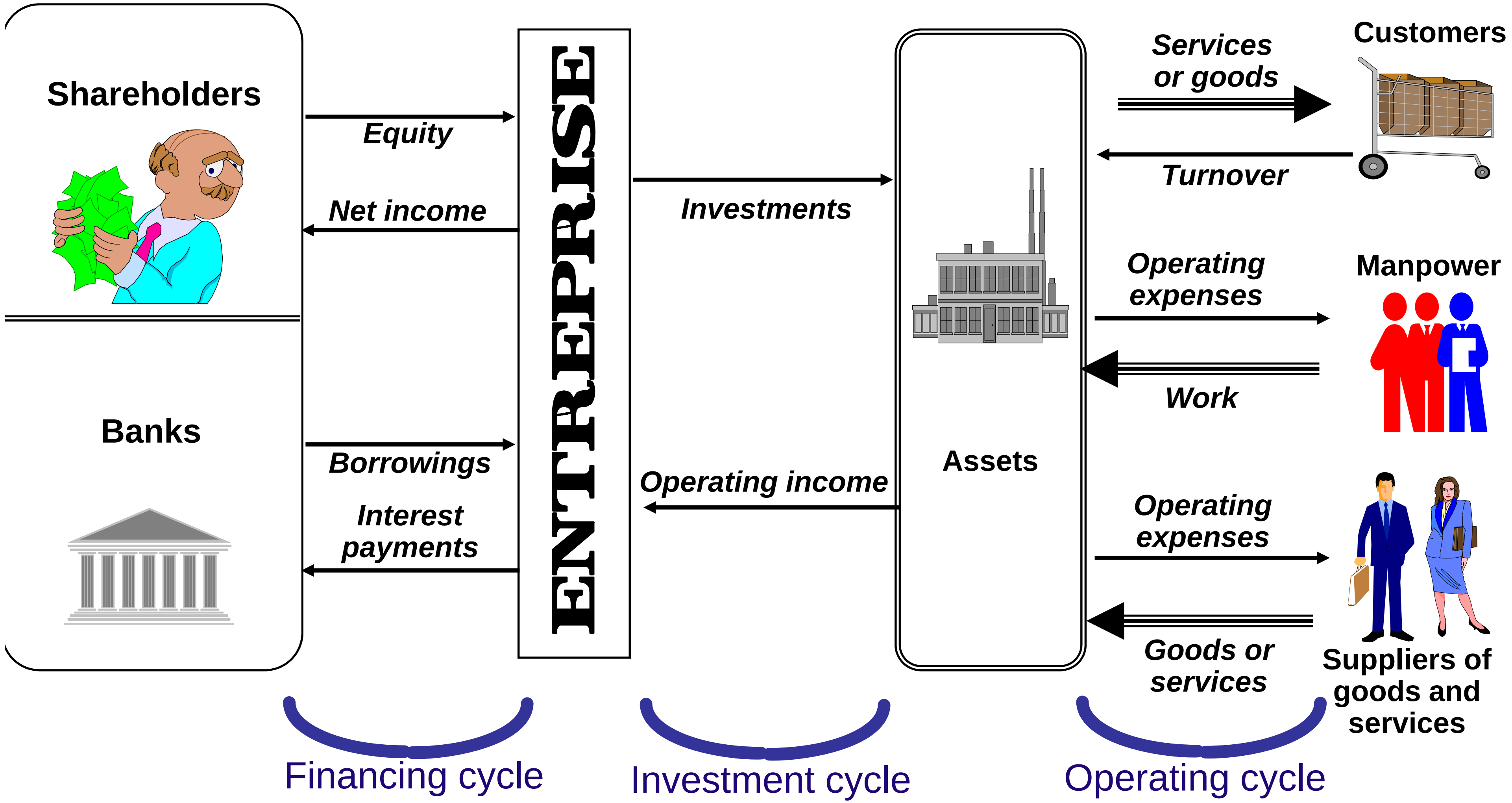
Professor Pascal DUMONTIER

The purpose of financial reporting

The financial view of the firm



The financial view of the firm



Financing activities

Only 2 ways of financing investments (capital expenditures):

- **borrowing money from a bank or by issuing bonds or notes**
- **selling new shares to investors**

Financing activities

When it borrows money, the firm becomes a debtor. The lender is a creditor.

Creditors invest money in the company but they do not control how the money is used.

As a consequence, creditors require fixed payments that will be paid at an agreed-upon time.

Financing activities

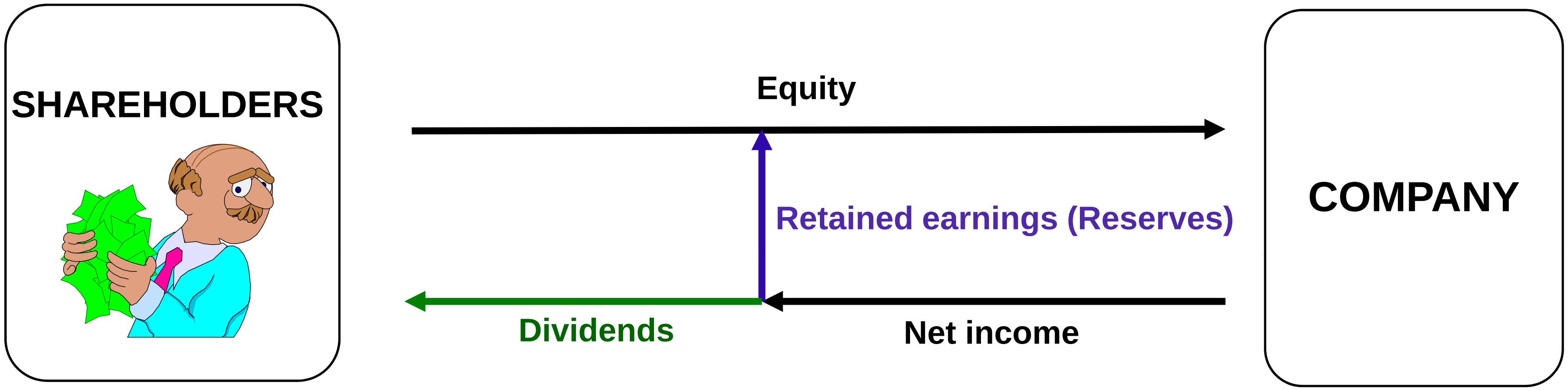
Shareholders, who finance the company by buying shares, are the owners of the firm.

They are those who decide how the money obtained from stock issues and from borrowings is used.

As a consequence, they can not require fixed payments. Dividends depend on firm performance.

Financing activities

Net income • Dividends • Retained earnings



Net income = Dividends + Retained earnings

Financing activities

Shareholders should focus on earnings, not on dividends

Earnings (and not dividends) are the remuneration of shareholders for providing the firm with equity.

Dividends do not increase shareholders' wealth. They are only aimed at satisfying their liquidity needs.

The impact of dividends on shareholders' wealth

You hold a stock of the Geneva Company (GC). The stock price is 100. The stock will pay a dividend of 20 in the next 5 minutes.

What should the stock price just after the dividend payment?

What should your ex-dividend wealth be?

Financing activities

Why are dividends puzzling?

The GC stock price is 100. What will be the wealth and the cash position of a shareholder who holds 5 GC stocks if

a) the company pays a dividend of 20 per share

b) the company does not pay dividends, but the shareholder sells one of his shares?

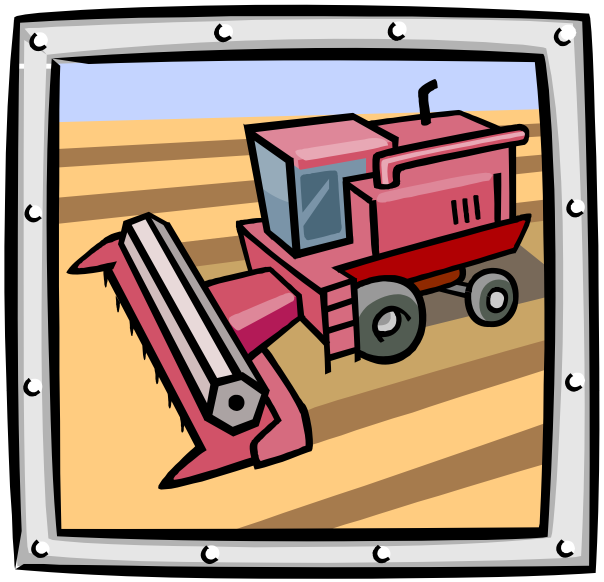
If it does not pay dividends, what should GC do to attract shareholders with strong liquidity needs?

As dividends are more heavily taxed than capital gains, why do companies pay and why do shareholders like dividends?

Investing activities

Investing activities deal with what a firm does with the money it receives from shareholders and banks.

These financial resources are used to purchase the assets with which the firm operates.



Operating activities

Primary activity of business

- Selling goods
- Providing services

Sources of revenue

- Purchasing merchandises or raw materials
- Manufacturing
- Advertising
- Paying employees
- Paying utilities

Sources of expense

Financial reporting and capital markets

Financial reporting and capital markets

The 'old' Legal Compliance Model

- ➢ **Managers are shareholders themselves**
- ➢ **Companies are financed for large amounts by a small number of banks**

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- ✓ **Investors have a direct access to information. They do not need accounting figures to evaluate the position of the firm. The demand for public disclosure is low.**
- ✓ **Accounting numbers are mainly the basis for determining taxes.**

Financial reporting and capital markets

The ‘new’ Full Disclosure Model

- ➢ Managers are not shareholders themselves
- ➢ Companies are financed for small amounts by numerous bondholders

↓

- ✓ Investors have no direct access to information. They use accounting figures to evaluate the position of the firm. The demand for public disclosure is high.
- ✓ Accounting numbers are used to anticipate future cash flows.

Financial reporting and capital markets

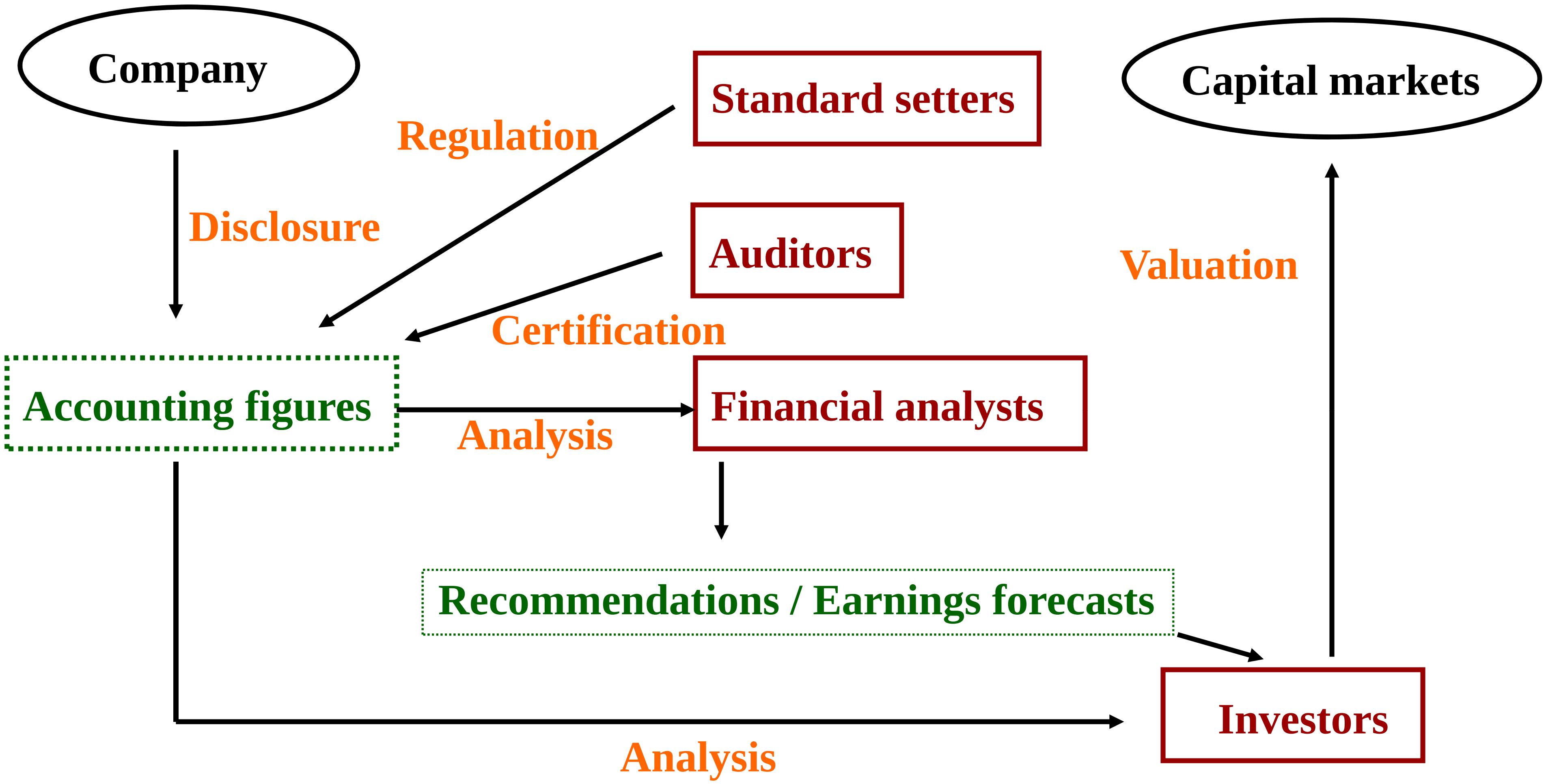
Company

~~Direct transfert of information~~

Individual investors

Capital markets

Financial reporting and capital markets



Financial reporting and capital markets

Stock market reaction at earnings' announcements

The information content of annual earnings announcements and mandatory adoption of IFRS ☆

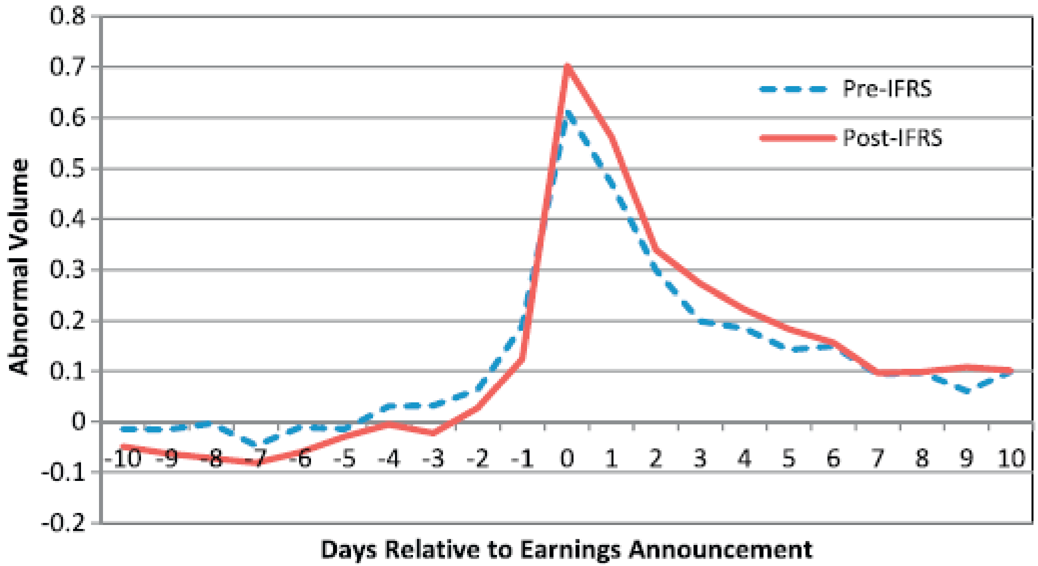
Wayne R. Landsman[a,*], Edward L. Maydew[a,1], Jacob R. Thornock[b,2]

Journal of Accounting and Economics 53 (2012) 34–54

Country	Year						
	2002	2003	2004	2005	2006	2007	Total
Australia	209	201	209	227	250	141	1,237
Belgium	37	36	30	41	44	42	230
Denmark	33	33	44	45	43	45	243
Finland	43	42	43	53	63	69	313
France	196	179	190	205	229	188	1,187
Germany	70	64	61	73	95	86	449
Greece	61	61	47	58	61	44	332
Hong Kong	143	159	167	180	206	160	1,015
Italy	30	28	29	43	51	45	226
Netherlands	80	83	80	77	75	61	456
Norway	48	52	53	77	81	89	400
South Africa	77	65	62	68	68	69	409
Spain	89	85	72	75	77	73	471
Sweden	95	94	85	93	101	117	585
Switzerland	34	33	32	40	48	51	238
United Kingdom	366	391	400	516	528	507	2,708
Total	1,611	1,606	1,604	1,871	2,020	1,787	10,499

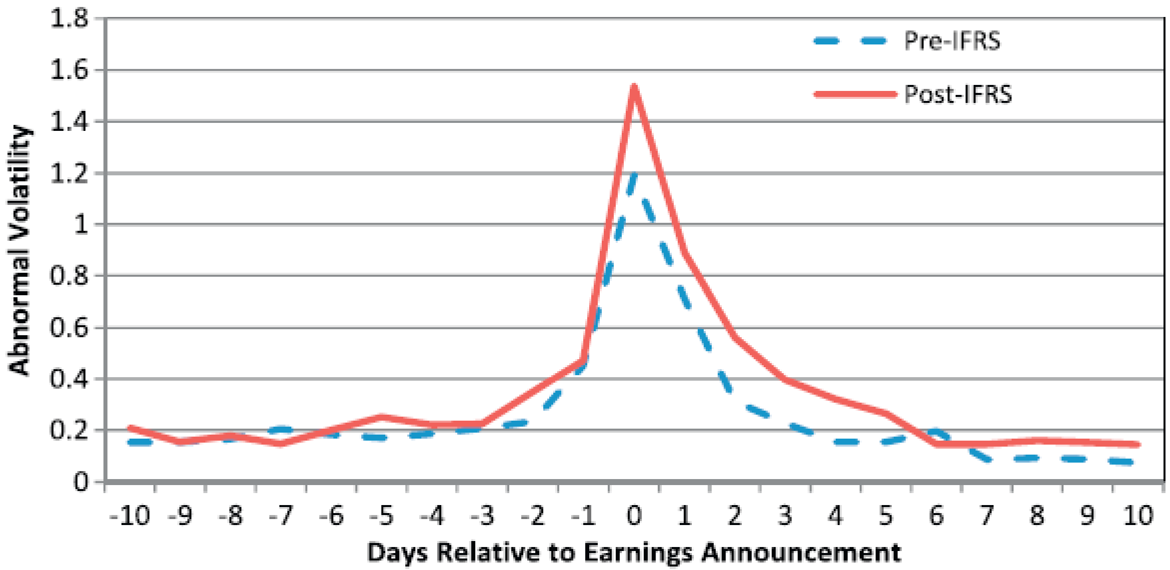
Financial reporting and capital markets

Abnormal trading volume around earnings' announcements



Financial reporting and capital markets

Abnormal price volatility around earnings' announcements



Why are accounting rules necessary?

A few examples

Example 1

In 1992, to run its business, a company has acquired a building in Geneva for CHF 10 millions. To-day, the value of the building is estimated at CHF 27 millions.

What should be the reported value of the building?

IAS16 specifies that fixed assets are carried either at cost (less accumulated depreciation and impairment) or at fair-value (less subsequent depreciation and impairment), provided that fair value can be measured reliably.

Increases in value resulting from revaluation must be credited directly to equity (and not to net income).

A few examples

Example 2

Paul has open several shops throughout Switzerland, creating a new brand "Immermore". He believes that this brand is the main asset of his company. He estimates its value at more than CHF 50 millions.

Should the brand be reported with the intangible assets of the company?

IAS 38 requires an entity to recognize an intangible asset if the asset is acquired and if the cash flows attributable to the asset will flow to the firm. If the asset is self-created, it is booked only if the cost of the asset can be measured reliably. Therefore brands, publishing titles, customer lists and items similar in substance that are internally generated should not be recognized as assets.

A few examples

Example 3

October 10: A car seller receives CHF2’000 from Mr B. who has ordered a new car that is CHF40’000 worth.

October 20: Mr B. receives his new car. He does not pay anything to the car seller.

November 6: The car seller receives CHF38’000 from Mr B.

When should the proceeds of this sale be recognized in the car seller revenues ? When should it affect profits ?

IAS 18 requires that revenue arising from the sale of goods are recognized when the risks and rewards of ownership have been transferred to the buyer .

The main accounting standards and their impact on accounting data

IAS-IFRS and US GAAP

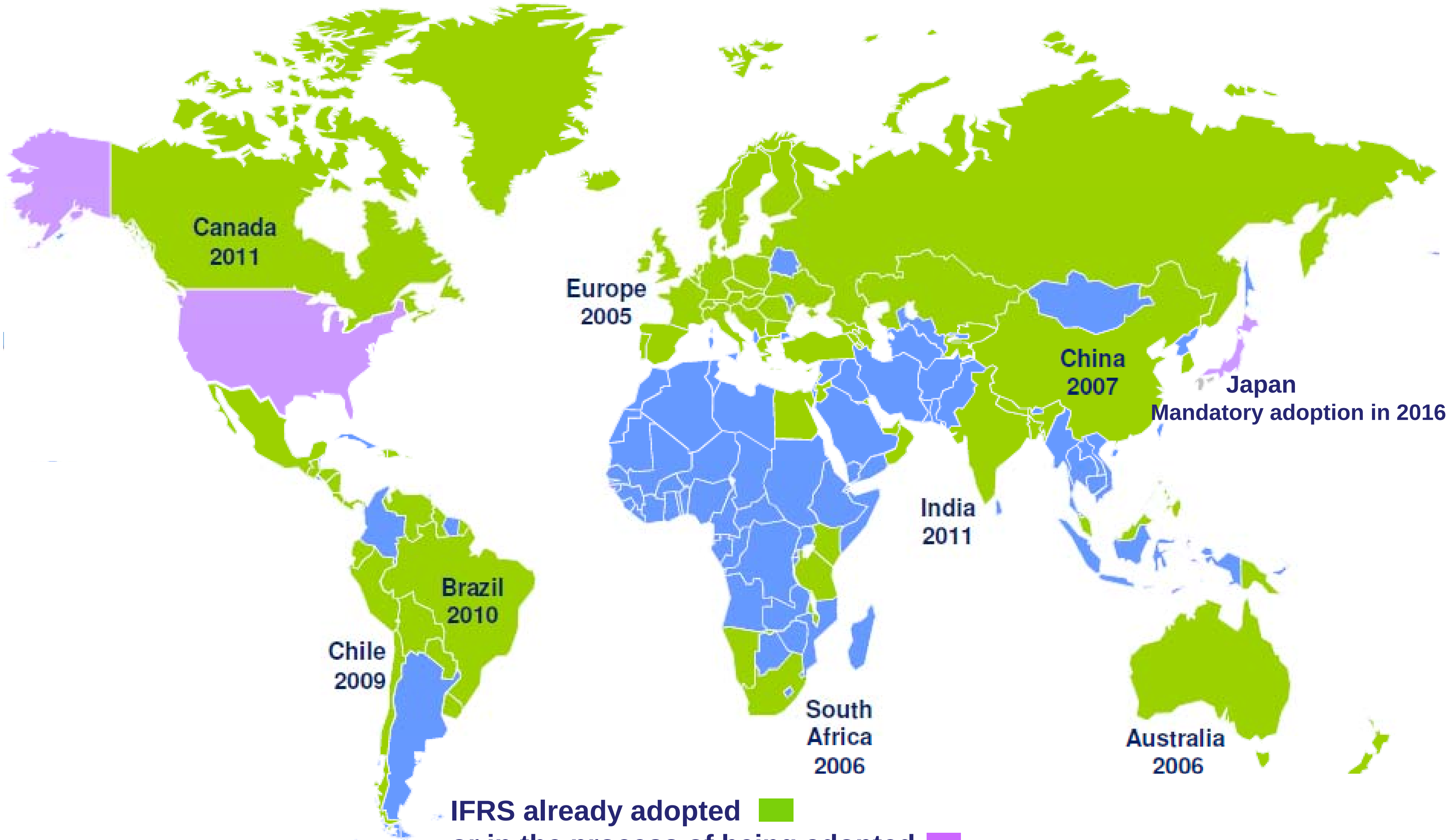
- In the US, the Financial Accounting Standards Board promulgates the FAS (Financial Accounting Standards) known as US GAAP.
- From 2005 onwards, all European listed companies have to comply with the IAS-IFRS promulgated by the IASB.

IAS = International Accounting Standards

IFRS = International Financial Reporting Standards

IASB = International Accounting Standards Board

IAS-IFRS and US GAAP



IFRS already adopted

or in the process of being adopted

The impact of GAAP on accounting figures

Novartis ***(in millions USD)***

2005	**IFRS**	**US GAAP**
Net income	**6 141**	**5 190**
Equity	**33 164**	**38 300**
ROE	**18,5%**	**13,6%**

UBS ***(in millions USD)***

2006	**IFRS**	**US GAAP**
Net income	**12 257**	**11 486**
Equity	**49 686**	**64 523**
ROE	**24,7%**	**17,8%**

The impact of accounting standards on financial data

Summary - Major Changes Restatement 2004

in million of CHF	Swiss GAAP ARR 2004	IFRS 2004	Changes	*Notes*
Total assets	912	**1057**	145	*Impact fair value, intangibles, real estate, other*
Liabilities	480	**491**	11	*Employee benefits, other*
Shareholders' equity, group's interest	381	**515**	134	
ARR : Net liquidity	41	**-**		*New definition*
IFRS : Cash and cash equivalents	-	**57**		
Operating result (EBIT)	67	**76**	9	*Reclassifications +13, new standards -4*
Net result	53	**56**	3	*New standards*
Cash flows from operating activities	50	**50**		

What are the right numbers?

Why are cash flows not affected by the accounting changes?

PUBLI*Groupe*

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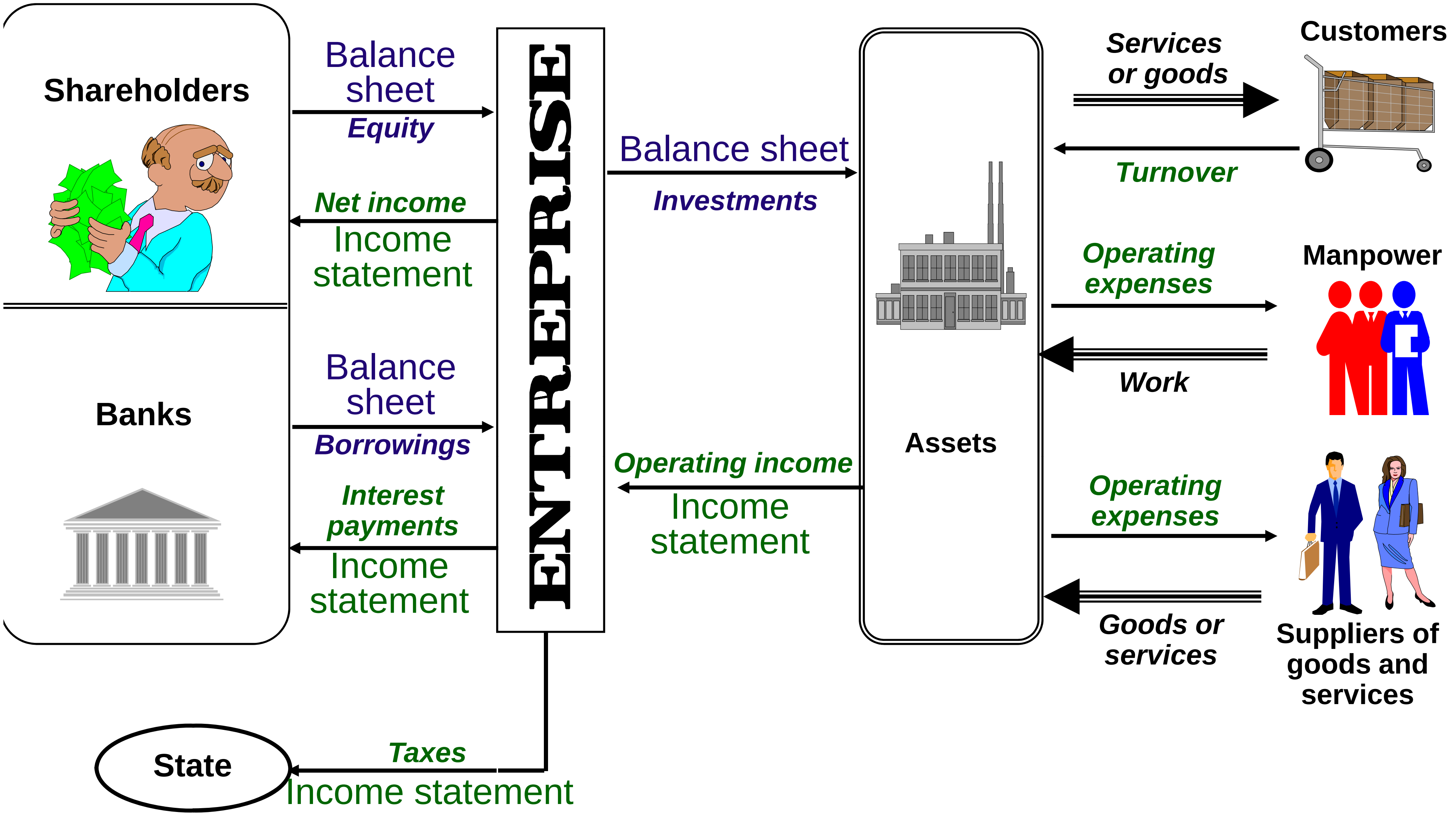
Content of financial statements

Content of financial statements



Content of financial statements

Firms communicate with external users (outsiders) through financial statements. They include:

A balance sheet (Assets = Owners' equity + liabilities)

An income statement (Revenue – expenses = Net income)

A statement of cash flows (Flows related to operating, investing and financing activities)

A statement of changes in equity (Equity in N = Equity in N-1 + Net Income – Dividends + Proceeds from share issues)

Notes to financial statements (Summary of accounting policy and explanations of accounting methods)

The balance sheet structure

Balance sheet as of December 31, 20XX

Assets
Current assets
Cash
Marketable securities
Accounts receivable
Inventories
Fixed assets (non-current assets)
Property, plant and equipment (tangible assets)
Intangible fixes assets
Investments (in financial assets)

The balance sheet

Balance sheet as of December 31, 20XX

Equity and liabilities
Current liabilities
Accounts payable
Financial liabilities (Non-current liabilities)
Bank loan
Issued debt securities
Shareholders' equity
Share capital
Retained earnings (Reserves)
Net income

The income statement structure

Income statement for the 20XX period

By nature

Net sales
- Cost of goods sold
- Wages and salaries
- Operating asset depreciation
- Other operating expenses

By function

Net sales
- Cost of goods sold
- Selling & mktg
- R&D
- Administration

Operating income (EBIT)
- Interest payments
- Corporate income tax

- Net income

The cash flow statement

Cash flow statement for the 20XX period

Cash flow statement

Cash flows from operating activities

- **Cash inflows from operations**
- **Cash outflows from operations**

Cash flows from investing activities

- **Acquisitions of fixed assets**
- **Sales of fixed assets**

Cash flows from financing activities

- **Issuance of common stock or debt securities**
- **Repayment of financial debts**

Cash inflows – Cash outflows = Changes in cash

Cash at beginning + Changes in cash = Cash at year end

Content of financial statements

Notes to financial statements

- **Clarify information in financial statements**
- **Expand financial statement data with additional details**
- **Describe accounting policies**

Principles of accrual accounting

Accrual accounting

Fundamental principles of financial accounting

Periodicity principle:

Time is divided into periods. An accounting time period cannot exceed 1 year.

Revenue recognition principle:

Revenues are recognized in the period in which they are earned (i.e. when the service has been provided, when goods have been delivered)**.**

Matching principle:

Expenses are recognized in the period in which the revenues they helped produce are recorded.

Consequently, revenues (expenses) are not recorded when cash is received (paid). Recognition is made before (or after) cash is paid or collected.

Accrual accounting

Periodicity principle

Life of business is divided into artificial time period

Revenue recognition

Revenue is recorded when it is earned

Matching principle

Expenses are recognized when revenues are recorded

Accrual accounting

Anna decided to start her own business. She rent a shop in a mall to open a sporting goods store. On January 2, she invested 420 in her firm equity. She also paid 280 in cash for furniture and equipment that will be depreciated over 5 years. During the first year of operation, she purchased sporting goods for 330, but only 290 have been paid out. She sold goods for 510, but only 340 were paid in. Operating expenses amounted to 85 for the year. They were all paid out, but the electricity bill for December was not yet received at the end of December. It was expected to come to 5. Finally, Anna paid 13 rents during the year, amounting to 6 each. The thirteenth one was related to the first month of the following fiscal year. At year end, the value of Anna's inventory was 46.

What is Anna's cash position at year end? What is her net income for the year? Show the company's balance sheet as of December 31.

Accrual accounting

Cash flow statement	
Flows from investing activities	
Furniture and equipment	-280
Flows from financing activities	
Share capital	420
Flows from operations	
Sales paid in	340
Purchases paid out	-290
Expenses paid out	-85
Rents paid out	-78
Change in cash	27
Cash at beginning of the year	0
Cash at year end	27

Accrual accounting

Income statement		
Sales	510	
Cost of goods sold	-284	(330-46)
Other operating expenses	-90	(85+5)
Rents	-72	(12x6)
Depreciation expense	-56	(280/5)
Net income	8	

Accrual accounting

Balance sheet			
Furniture and equipment	224	Share capital	420
Inventory	46	Net income	8
Pre-paid rent	6	Payables	40
Receivables	170	Unrecognized expense	5
Cash	27		
	473		473