





Module 1

Understanding financial statements

Introduction to understanding financial statements



01.

Help you read a company's annual report

03.

The related notes to the financial statements

02.

The balance sheet

The three key financial statements



Balance sheet

Statement of financial position



Income statement

Statement of operation / profit and loss



Statement of cash flows



Balance sheet



Income statement

\$0 **\$13,650**

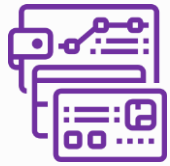
Fiscal year



Statement of cash flows



The opening
cash balance



All cash
transactions



The closing
cash balance

The transactions are **sorted by activity type:**



Operating



Investing



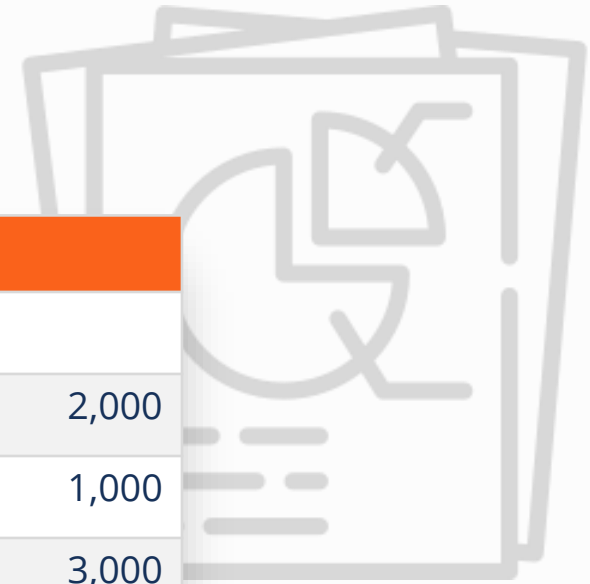
Financing



Simplified balance sheet

Assets	
Current assets	
Cash	20,000
Accounts receivable	3,000
Inventory	60,000
Prepaid expenses	11,000
Total current assets	94,000
Non current assets	
Property Plant & Equipment	110,000
Intangible assets	10,000
Total non current assets	120,000
Total assets	214,000

Liabilities	
Current liabilities	
Accounts payable	2,000
Accrued expenses	1,000
Total current liabilities	3,000
Non current liabilities	11,000
Bank loan	100,000
Shareholder equity	
Common shares	89,000
Retained Earnings	11,000
Total liabilities and shareholders equity	214,000



Simplified balance sheet



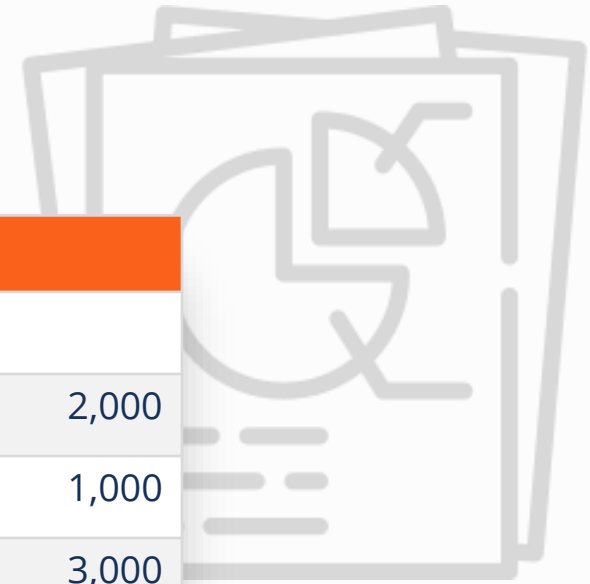
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Total non current assets	120,000
Total assets	214,000
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Current vs non-current



Assets

Current

Expected to be converted into cash in less than 1 year

Accounts receivable, inventory

Non-current

Expected to be held greater than 1 year

Property, plant, and equipment



Liabilities

Current

Will be paid in less than 1 year

Trade accounts payable

Non-current

Repayment terms longer than 1 year

Loan repayable over a 5 year period

Balance sheet demonstration

Espresso Software Comparative Balance Sheet

(in millions)

June 30,	2018	2017
Assets		
Current Assets:		
Cash and cash equivalents	\$ 5,505	6,076
Short-term investments (including securities loaned of \$62 and \$1,540)	31,283	25,371
Total Cash, cash equivalents, and short-term investments	36,788	31,447
Accounts receivable, net of allowance for doubtful accounts of \$375 and \$451	13,014	11,192
Inventories	740	717
Deferred income taxes	2,184	2,213
Other	2,950	3,711
Total current assets	55,676	49,280
Property and equipment, net of accumulated depreciation of \$8,629 and \$7,547	7,630	7,535
Equity and other investments	7,754	4,933
Goodwill	12,394	12,503
Intangible assets, net	1,158	1,759

Investments



A company will hold external investments for two reasons:

- Excess cash
- Accumulating cash to make a large purchase

External investments:

Investments in equity or debt instruments to be held for capital gain and/or income

Short term
(less than year)

Long term
(more than year)



Investments



A company can also make internal investments

Internal investments

Investment in subsidiaries, associates and joint ventures

Short term
(less than year)

Long term
(more than year)



Deferred income tax

Espresso Software Comparative Balance Sheet

(in millions)

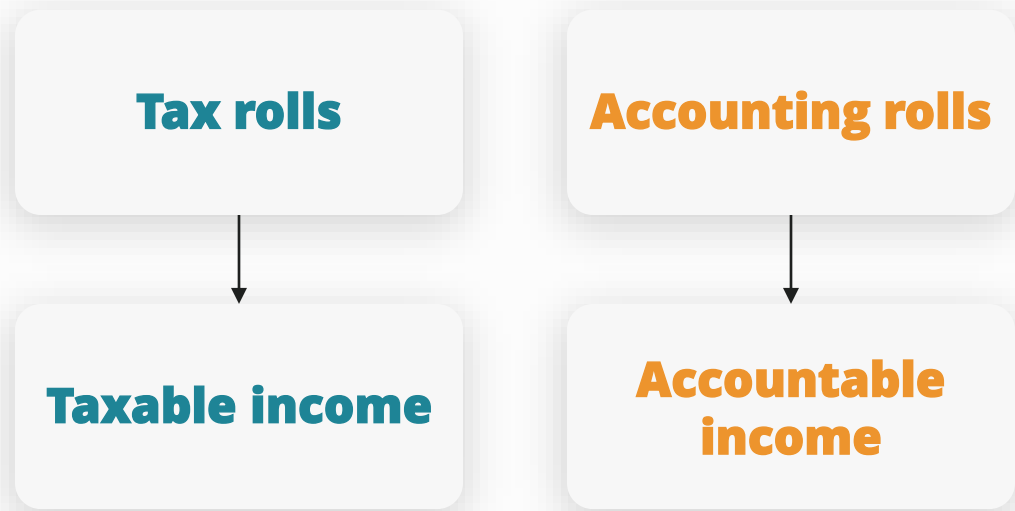
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Total assets	86,113	77,888
Liabilities and stockholder's equity		
Current liabilities		
Accounts payable	\$ 4,025	3,324
Short-term debt	1,000	2,000
Accrued compensation	3,283	3,156
Income taxes	1,074	725
Short-term unearned revenue	13,652	13,003

Deferred income tax

Property and equipment, net of accumulated depreciation of \$8,925 and \$7,547	7,630	7,535
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Securities lending payable	182	1,684
Other	2,931	3,142
Total current liabilities	26,147	27,034
Long-term debt	4,939	346
Long-term unearned revenue	1,178	1,281
Deferred income taxes	229	0
Other long-term liabilities	7,445	6,269
Commitments and contingencies		
Stockholder's equity:		
Common stock and paid-in capital - shares authorized 24,000; outstanding 8,668 and 8,908	62,856	62,382
Retained deficit, including accumulated other comprehensive income of \$1,055 and \$969	-16,681	-22,824
Total stockholder's equity	46,175	39,558
Total liabilities and stockholder's equity	86,113	74,488

See accompanying notes.

Deferred income tax



accounting income
+ accounting depreciation (e.g. **straight-line method**)
- tax depreciation (e.g. **declining balance method**)

taxable income



Deferred income tax

Espresso Software Comparative Balance Sheet

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What is goodwill?



Goodwill

- Non-current asset
- Company has intangible value

e.g. brand, customers, intellectual capital

If a company is **purchased for more** than the fair value of **net assets** (assets less liabilities):

Purchase price	X
Fair value of net assets acquired	(X)
Goodwill	X



Intangible assets

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



Trademarks



Patents



Copyrights

Source: Gartner, eMarketer, Statista

Unearned revenue

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

e.g. licenses, subscriptions

12 month subscription sold for \$1,200 in January

Earned:	\$100	\$300	\$600	\$900	\$1,200
	Jan	Mar	Jun	Sep	Dec
Unearned:	\$1,100	\$900	\$600	\$300	\$0



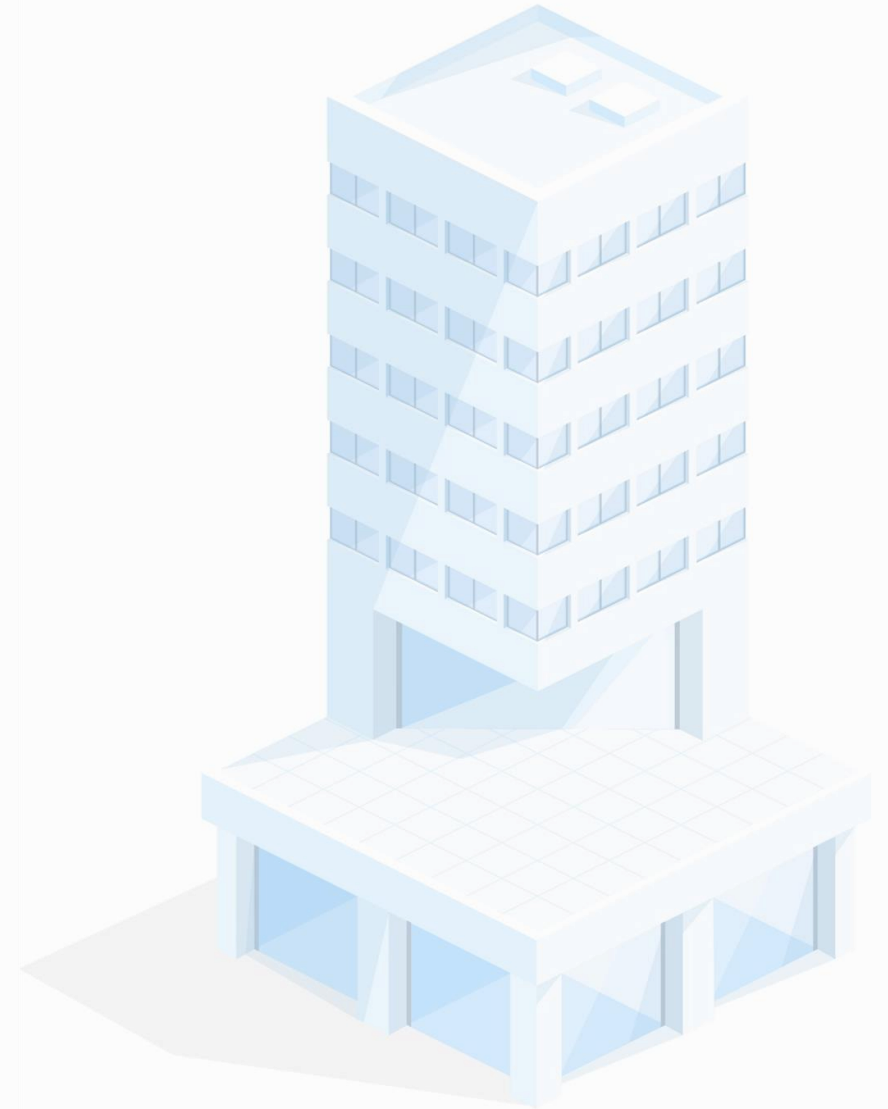
Source: Gartner, eMarketer, Statista

Commitments

Commitments are future obligations that a company agrees to.



New buildings, building improvements, leasehold improvements



Contingencies

Contingencies are liabilities that may or may not happen, depending on circumstance.

e.g. lawsuit

The liability must be recorded if:

1. A **loss** will be suffered in the future
2. The loss **amount** can be reasonably estimated

If not, just disclose a note.

Contingent gains are never recorded in financial statements.



Common vs preferred shares

Liabilities and stockholder's equity

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See accompanying notes.

Common vs preferred shares

Common shares



Allow for participation in the profits of the company

- Comes in the form of a dividend



Allow for voting rights in a company

- One vote for every share held



if dissolved, any residual amount after everyone else is paid would go to the common shareholders



Common vs preferred shares

Preferred shares



Offer investors a fixed dividend

- It may not be paid annually



Will accumulate/pay before common share dividends



Most businesses don't issue because they are viewed as debt with a tax disadvantage

- Dividends do not reduce taxable income

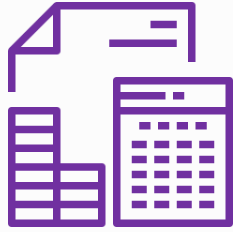


Authorized vs outstanding share capital

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Authorized vs outstanding share capital



Authorized shares

- The total number of shares a company can sell

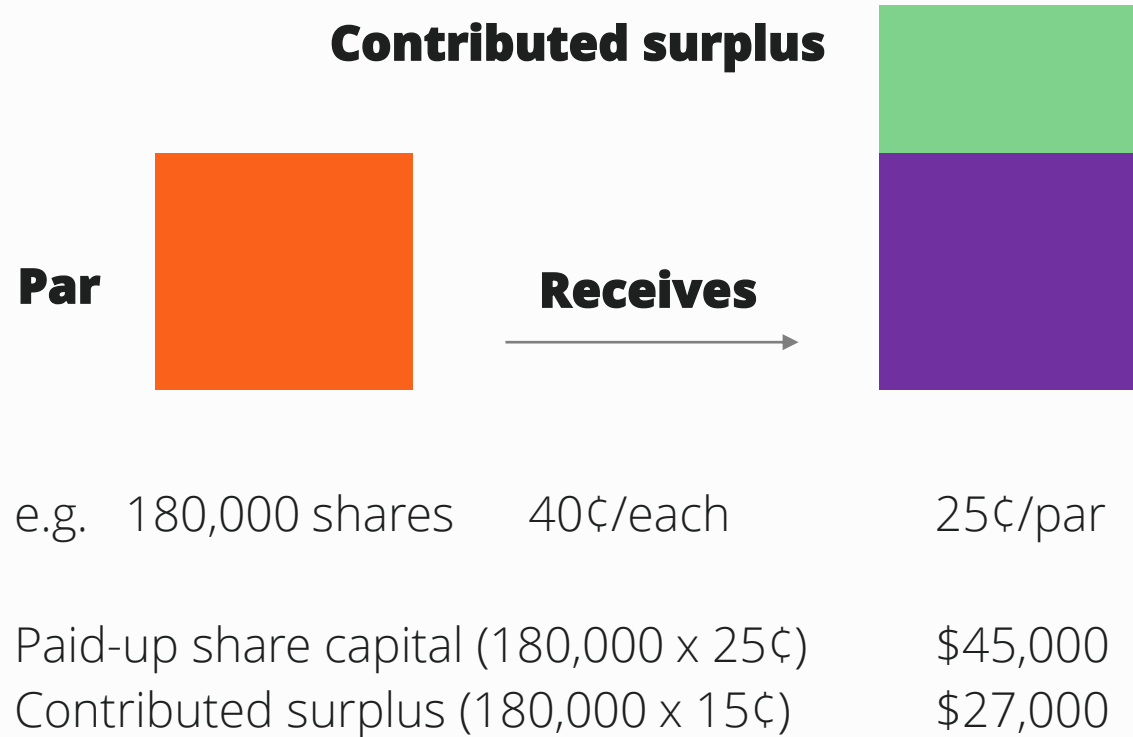
VS



Outstanding shares

- The total number of shares a company has sold

Contributed surplus



Other comprehensive income

Other comprehensive income (OCI):

- certain company gains and losses that are not always recorded through the income statement

e.g. unrealized gains

and losses on investments and hedging instruments



Balance sheet component matching exercise



You can find these links on the attachment tab

1. Open the **Balance sheet component matching exercise**
2. Open the **Balance sheet component matching solution**



Statement of shareholders' equity

Espresso Software Comparative Balance Sheet

(in millions)

June 30, 2018 2017

Assets

Current Assets:

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Liabilities and stockholder's equity

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Long-term unearned revenue		1,178	1,281
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Commitments and contingencies

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See accompanying notes.

Statement of shareholders' equity

Stockholders' Equity Statements

(in millions)

Year Ended June 30,

2018

2017

2016

Common stock and paid-in capital

Balance, beginning of period	\$ 62,382	62,849	60,557
Common stock issued	2,311	567	3,504
Common stock repurchased	(3,113)	(2,611)	(3,022)
Stock-based compensation expense	1,891	1,708	1,479
Stock-based compensation income tax benefits (deficiencies)	(647)	(128)	253
Other, net	32	(3)	78
Balance, end of period	62,856	62,382	62,849

Retained deficit

Balance, beginning of period	(22,824)	(26,563)	(29,460)
Cumulative effect of a change in accounting principle relating to uncertain tax positions	0	0	(395)
Cumulative effect of a change in accounting principle relating to costs of certain compensated absences	0	0	(17)
Net income	18,760	14,569	17,681
Other comprehensive income			
Net unrealized gains on derivatives	27	302	18
Net unrealized gains (losses) on investments	265	(233)	(653)
Translation adjustments and other	(206)	(240)	121
Comprehensive income	18,846	14,398	17,167
Common stock cash dividends	(4,547)	(4,620)	(4,084)
Common stock repurchased	(8,156)	(6,039)	(9,774)
Balance, end of period	(16,681)	(22,824)	(26,151)
Total stockholders' equity	46,175	39,558	36,698

The full disclosure principle

Liabilities and stockholder's equity

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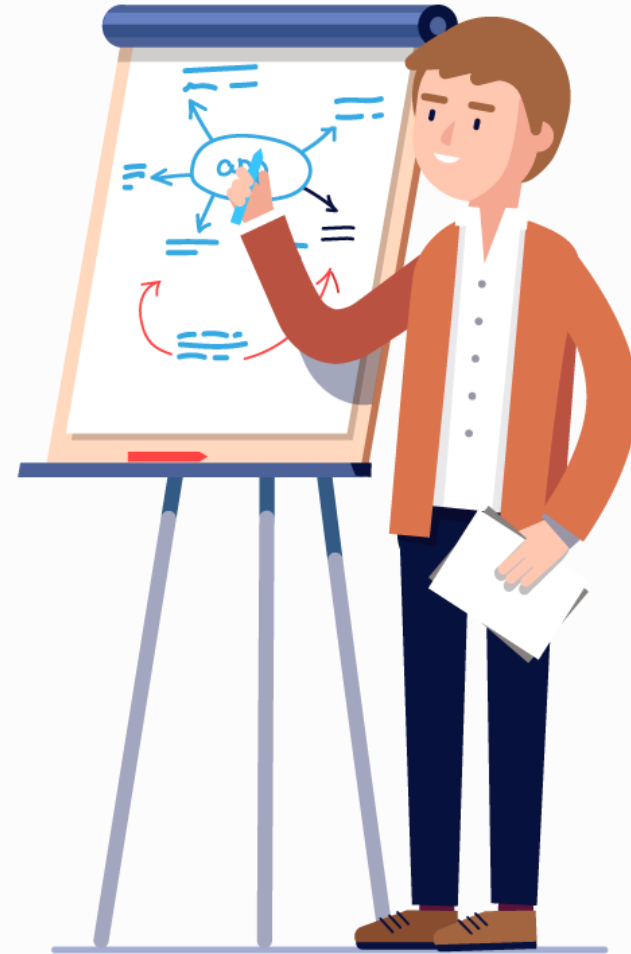
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The full disclosure principle

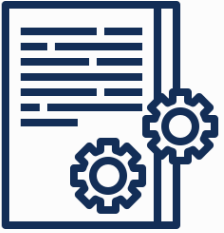
For full disclosure:



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



Three key financial statements notes



**Significant
accounting
policies**



Direct information



**Indirect
information**



Significant accounting policies



**Company
accounting
standards**



**How inventory &
investments are
valued**



**Financial
instruments**



**Revenue is
recognized**



**Property, plant &
equipment is
amortized**



**Any other
policies**



Direct information



A breakdown of
the types of
investments



Debt and
financial
instruments

What is included in:

Inventory

**Intangible
assets**

PP&E

Income taxes



Indirect information

Notes of **indirect information**:

- Help provide the entire financial picture of an organization
- Not related to the numbers in the financial statements

Commitments

Contingencies

**Stock based
compensation
plans**



Noteworthy exercise



You can find these links on the attachment tab

1. Open the **Noteworthy exercise** with instructions
2. Open the **Noteworthy solution** for results





Module 2

Understanding the income statement and cash flow

Reading financial statements overview



01.

The income statement

02.

Statement of cash flows

03.

The key contents of an annual report

The three key financial statements



1. Balance sheet

Assets

Liabilities

Equity



2. Income statement

Revenues

Expenses

Profit or loss



3. Statement of cash flows

Operating

Investing

Financing

The income statement

Espresso Software Financial Statements and Supplementary Data

Income Statements

(in millions, except per share amounts)

Year Ended June 30,	2018	2017	2016
Revenue			
Operating expenses:	\$ 62,382	62,849	60,557
Cost of revenue	2,311	567	3,504
Research and development	(3,113)	(2,611)	(3,022)
Sales and marketing	1,891	1,708	1,479
General and administrative	(647)	(128)	253
Employee severance	32	(3)	78
Total operating expenses	62,856	62,382	62,849
Operating income			
Other income	(22,824)	(26,563)	(29,460)
Other income (expense)	0	0	(395)
Income before income taxes	0	0	(17)
Provision for income taxes	18,760	14,569	17,681
Net income	27	302	18
Earnings per share:	265	(233)	(653)
Basic	(206)	(240)	121
Diluted	18,846	14,398	17,167
Weighted average shares outstanding:	(4,547)	(4,620)	(4,084)
Basic	(8,156)	(6,039)	(9,774)
Diluted	(16,681)	(22,824)	(26,151)
Cash dividends declared per common share	46,175	39,558	36,698

The income statement

Espresso Software Financial Statements and Supplementary Data			
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\$13,650

Fiscal year

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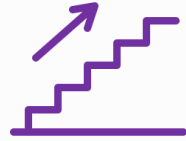
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Basic	(8,156)	(6,039)	(9,774)
Diluted	(16,681)	(22,824)	(26,151)
Cash dividends declared per common share	46,175	39,558	36,698

Single step vs multi-step income statements



Single step

Example:
Revenue (+)
Gains (+)
Total revenue
Cost of Goods Sold (-)
Selling, General & Administrative (-)
Losses (-)
Other Expenses (-)
Total expenses
Income taxes (-)
Net income

VS



Multiple step

Example:
Revenue (+)
Cost of Goods Sold (-)
Gross Profit
Selling, General & Administrative (-)
Operating income
Gains (+)
Losses (-)
Other Expenses (-)
Pre-tax income
Income taxes (-)
Net income

Cost of sales

Cost of goods sold or **Cost of sales**:

- May be shown as a summarized line item
- May be broken down to its expense items



Direct materials

(e.g. materials used in manufacturing)



Direct labour

(e.g. professional services delivered)



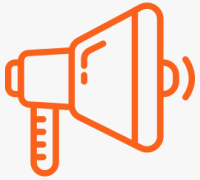
Direct overhead

(to the production of the goods or services)



Selling, general and administrative expenses

Selling, general and administrative, or SG&A contains a large number of expense items, such as:



Advertising and promotion costs



Legal, insurance
and accounting
expenses



Office supplies



Rent



Other related expenses

Gains and losses

Gains and losses may appear separately or grouped after all operating items under “other income or expenses”. **They are related to activities that are incidental to operations such as:**



Sale of investments



Foreign exchange translations



Financial instrument transactions



Espresso Software income statement exercise

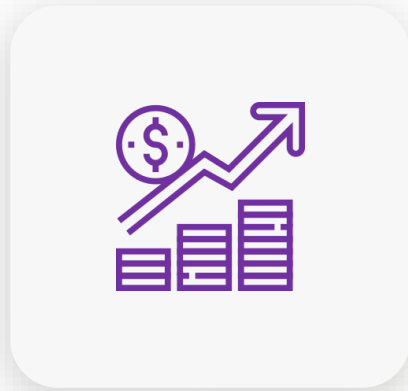


You can find these links on the attachment tab

1. Open the **Espresso Software income statement exercise** with instructions
2. Open the **Espresso Software income statement solution** for results



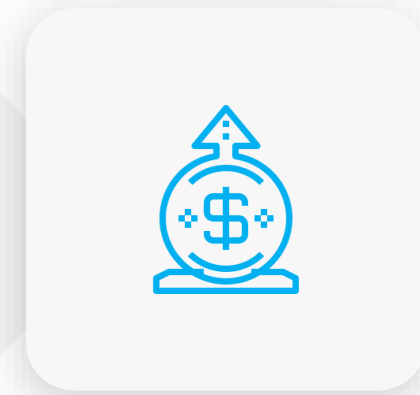
The cash flow statement



**Income
statement**



Balance sheet



**Cash flow
statement**

The cash flow activities

Statement of cash flows demonstrates

- Where cash is being generated
- Where cash is being used in the business



Operating



Investing



Financing

Operating activities



Operating



Day-to-day business operations;

Revenues and expenses that have been collected and paid during the year

Depreciation and amortization are **not** included.



Investing



Financing

Investing activities



Operating



Investing



Financing



Non-current assets that support the business.

- Property, plant, and equipment
- Business acquisitions

Financing activities



Operating



Investing



Financing

Transactions regarding
shares or **debt**

Company raises funds by either
borrowing or issuing shares.

Direct method vs indirect method



Direct method

Operating activities

Cash collected from customers

Cash paid to suppliers

Cash paid to employees

Cash flow from operating activities

Investing activities

Purchase of equipment

Disposal of property

Cash flow from investing activities

Financing activities

Issuance of shares

Repayment of debt

Cash flow from financing activities

Net movement in cash

=



Indirect method

Operating activities

Net income

Add back depreciation and amortization

Adjust change in working capital balances

Cash flow from operating activities

Investing activities

Purchase of equipment

Disposal of property

Cash flow from investing activities

Financing activities

Issuance of shares

Repayment of debt

Cash flow from financing activities

Net movement in cash

Direct method



Direct method

Operating activities

Cash collected from customers

Cash paid to suppliers

Cash paid to employees

Cash flow from operating activities

Investing activities

Purchase of equipment

Disposal of property

Cash flow from investing activities

Financing activities

Issuance of shares

Repayment of debt

Cash flow from financing activities

Net movement in cash

Direct method of cash flow starts with **cash transactions**.

(Transactions are separated into **cash received** and **cash paid**.)

Indirect method

Indirect method of cash flow starts with **net income**.

(Non-cash adjustments are then added.)

Accounts receivable
Inventory
Accounts payable



Indirect method

Operating activities

Net income

Add back depreciation and amortization

Adjust change in working capital balances

Cash flow from operating activities

Investing activities

Purchase of equipment

Disposal of property

Cash flow from investing activities

Financing activities

Issuance of shares

Repayment of debt

Cash flow from financing activities

Net movement in cash

Key elements in a cash flow statement



Net cash provided by operating activities

Represents operating 'lifeblood' of business after paying necessary outgoings for financing and tax

Changes in working capital

Shows whether business is absorbing funds for working capital or releasing them. Trend may indicate either financial stress or loose control over working capital

PPE investment

Companies must invest in PPE to maintain their productive capacity. A downward trend may indicate a declining company. Identify the necessary sustainable level of expenditure

Financing requirement/surplus

Shows whether internally generated funds are sufficient to cover investments made in fixed assets and businesses. Continuous deficits indicate that growth depends on regular injections of external finance

Espresso Software cash flow statement exercise



You can find these links on the attachment tab

1. Open the **Espresso Software cash flow statement exercise** with instructions
2. Open the **Espresso Software cash flow statement solution** for results



The benefits of an annual report

The annual report contains a significant amount of information:



Financial

- Management discussion & analysis (MD&A)
- Financial statements
- Notes to financial statements



Non-financial

- Messages from the Chair, CEO
- Corporate profile
- MD&A
- Risk and control processes and analysis



Contents of an annual report



The annual report will always include:

01.

Letter to the
shareholders

02.

Business
description

03.

Management's
Discussion and
Analysis (MD&A)

04.

Reporting on
internal controls

05.

Audit report

06.

Balance sheet,
Income Statement,
and Statement of
Cash Flows

07.

Notes to the
financial
statements

08.

Earnings per share

09.

Listing of directors
of the company

Management discussion and analysis

MD&A provides information regarding past performance and future strategic direction

**Acts as sort of
variance
analysis**

**Explains
company
performance**

**Lists future
actions to be
taken**

**Identifies the
key risks facing
the organization**



Espresso Software reporting challenge exercise



You can find these links on the attachment tab

1. Open the **Espresso Software reporting challenge exercise** with instructions
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Conclusion