

# FINANCIAL MANAGEMENT

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CH II

## Fundamental Financial Statements



# Learning Goals

Learn fundamental financial statements

Understand the key components of Balance Sheet

Evaluation of investing & financing decisions on balance sheet

Understand the key components of Income Statement

## Planning

### Investing

#### Current:

- Cash
- Accounts Receivable
- Inventories
- Marketable Securities

#### Noncurrent:

- Land, Buildings, & Equipment
- Patents
- Investments

### Operating

- Sales
- Cost of Goods Sold
- Selling Expense
- Administrative Expense
- Interest Expense
- Income Tax Expense

### Financing

#### Current:

- Notes Payable
- Accounts Payable
- Salaries Payable
- Income Tax Payable

#### Noncurrent:

- Bonds Payable
- Common Stock
- Retained Earnings

#### Net Income



#### Income statement

#### Cash Flow



#### Statement of Cash Flows

#### Liabilities & Equity



#### Balance Sheet

#### Statement of Shareholders' Equity

#### Assets



#### Balance Sheet

# The Four Key Financial Statements

1. THE BALANCE SHEET
2. THE INCOME STATEMENT
3. STATEMENT OF CASH FLOWS
4. THE STATEMENT OF RETAINED EARNINGS

Understanding financial accounting is essential to understanding corporate finance

# The Balance Sheet

- Also called the statement of condition or the statement of financial position
- Shows the financial condition of a company on a particular date
- Summarizes what the firm owns and what the firm owes to outsiders and to internal owners

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' equity}$$

Assets are what the firm owns.

Liabilities are what the firm owes to outsiders.

Stockholders' equity is what the firm owes to internal owners.

# The Balance Sheet (BS)

- The balance sheet presents a summary of a firm's financial position at a *given point in time*.
- The statement balances the firm's assets (what it owns) against its financing, which can be either debt (what it owes) or equity (what was provided by owners).

# The Balance Sheet

## Current Assets

- Cash & Securities
- Receivables
- Inventories

+

## Fixed Assets

- Tangible Assets
- Intangible Assets

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**Total Assets**

=

## Current Liabilities

- Payables
- Short-term Debt

+

**Long-term Liabilities**

+

**Shareholders' Equity**

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**Total Liabilities &  
Shareholders' Equity**

# Balance Sheet (BS), BARLETT COMPANY (\$000)

Assets	December 31	
	2015	2014
Cash	\$ 363	\$ 288
Marketable securities	68	51
Accounts receivable	503	365
Inventories	<u>289</u>	<u>300</u>
Total current assets	<u>\$1,223</u>	<u>\$1,004</u>
Land and buildings	\$2,072	\$1,903
Machinery and equipment	1,866	1,693
Furniture and fixtures	358	316
Vehicles	275	314
Other (includes financial leases)	<u>98</u>	<u>96</u>
Total gross fixed assets (at cost)	<u>\$4,669</u>	<u>\$4,322</u>
Less: Accumulated depreciation	<u>2,295</u>	<u>2,056</u>
Net fixed assets	<u>\$2,374</u>	<u>\$2,266</u>
Total assets	<u>\$3,597</u>	<u>\$3,270</u>



# Balance Sheet (BS), BARLETT COMPANY (\$000)

(000\$)

Liabilities and Stockholders' Equity		
Accounts payable	\$ 382	\$ 270
Notes payable	79	99
Accruals	<u>159</u>	<u>114</u>
Total current liabilities	\$ 620	\$ 483
Long-term debt (includes financial leases)	<u>1,023</u>	<u>967</u>
Total liabilities	<u>\$1,643</u>	<u>\$1,450</u>
Preferred stock: cumulative 5%, \$100 par, 2,000 shares authorized and issued	\$ 200	\$ 200
Common stock: \$2.50 par, 100,000 shares authorized, shares issued and outstanding in 2015: 76,262; in 2014: 76,244	191	190
Paid-in capital in excess of par on common stock	428	418
Retained earnings	<u>1,135</u>	<u>1,012</u>
Total stockholders' equity	<u>\$1,954</u>	<u>\$1,820</u>
Total liabilities and stockholders' equity	<u>\$3,597</u>	<u>\$3,270</u>

# The Assets

Assets represent the uses of a firm's funds  
i.e. Assets show what the firm “owns”

Liquid Assets can be converted easily into cash

- Current vs. Fixed Assets

Current Assets that are likely to be used or turned into cash in the near future (usually within the next 12 months).

Fixed Assets that will not be used or converted into cash in the near future

# Current Assets

## Cash and Cash Equivalents

- Cash awaiting deposit
- Cash in a bank account
- Short-term investments that can be converted to cash within three months

## Marketable Securities

- Short-term investments that can be converted to cash within a year
- Three categories
  - Held to maturity
  - Trading securities
  - Securities available for sale

# Accounts Receivables

Customer balances outstanding on credit sales

- $\text{Net Realizable Value} = \text{Actual Amount of Account} - \text{Allowance for Doubtful Accounts}$

Allowance for doubtful accounts

- Affects balance sheet valuation
- Important in assessing earnings quality
- Should reflect volume of credit sales, past experiences with customers, customer base, credit policies, collections practices, and economic conditions

# Inventories

- Items held for sale
  - Items used in the manufacture of products that will be sold
  - Major revenue producer for most companies
- Retail companies
  - Finished goods
  - Manufacturing companies
  - Raw materials
  - Work-in-process
  - Finished goods
  - Service –oriented companies
  - Little or no inventory

# Fixed Assets

## Tangible Assets

- Property, Plant and Equipment (PP&E)
  - Less accumulated depreciation
  - Net tangible assets
- 
- Intangible Assets
- 
- Goodwill
  - The difference between actual price paid for the acquisition of a firm and its book value.
  - Arises when one company acquires another company for a price in excess of the fair market value of the net identifiable assets acquired

# Property, Plant and Equipment (PP&E)

- Land
- Buildings
- Leasehold improvements
- Construction in progress
- Equipment

## Land

Property used in business

## **Buildings**

Buildings owned by the company

Stores

Corporate offices

## **Construction in Progress**

Costs of constructing new buildings that are not yet complete

## **Equipment**

Original cost of machinery and equipment used in business operations

# Fixed Assets (Intangibles)

- Intangible assets lack physical substance and are not financial instruments.
- Include
  - patents,
  - copyrights,
  - franchises,
  - trademarks,
  - customer lists and

***Identifies the nature of business.***



# Goodwill

- Arises when one company acquires another company for a price in excess of the fair market value of the net identifiable assets acquired
- Evaluated annually
  - If no loss of value has occurred, goodwill remains on the balance sheet.
  - If the book value exceeds the fair value, the excess must be written off as an impairment expense (değer düşüklüğü)



# Liabilities (Long & Short Term)

Liabilities represent the sources of a firm's funding.  
(i.e. Liabilities represent what a firm “owes.”)

- Current vs. Long-Term Liabilities
  - Current Liabilities – Liabilities that are likely to be paid off within the next 12 months.
  - Long-Term Liabilities – Liabilities that are not likely to be paid off within the next 12 months.

# Balance Sheet (BS), BARLETT COMPANY (\$000)

(000\$)

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# Accounts Payables

Short-term obligations that arise from credit extended by suppliers for the purchase of goods and services

- Eliminated when the bill is satisfied
- Increase and decrease depending on
  - credit policies,
  - economic conditions, and
  - cyclical nature of operations

# Notes Payables

- Also referred to as short-term debt
- Short-term obligations in the form of promissory notes
- Lines of credit to suppliers or financial institutions

# Stockholders' Equity

- Also called shareholders' equity
  - Residual interest in assets that remains after deducting liabilities
  - Owners bear greatest risk and benefit from greatest rewards.
- 
- Shareholder's Equity
  - Common Stock
  - Additional Paid-in Capital
  - Retained Earnings
  - Other Equity Accounts

# Stockholders' Equity – common stock

- Shareholders
  - do not ordinarily receive a fixed return
  - have voting privileges in proportion to ownership interest
  - can benefit through price appreciation
  - can suffer through price depreciation

## Common Stock

- Dividends are declared at the discretion of a company's board of directors
- Amount listed on the balance sheet is based on the par or stated value of the shares issued (which bears no relationship to actual market price).

## Preferred Stock

- Carries a fixed annual dividend payment

# Stockholders' Equity – Retained Earnings

Retained Earnings — earned capital of a company; reflects accumulation of undistributed earnings or losses since inception; retained earnings is the main source of dividend distributions

## Cash and Stock Dividends

- Cash dividend — distribution of cash (or assets) to shareholders
- Stock dividend — distribution of capital stock to shareholders



# *The Income Statement*

- The income statement provides a financial summary of a company's operating results during a specified period.
- Although they are prepared quarterly for reporting purposes, they are generally computed monthly by management and quarterly for tax purposes.

# Income Statement (IS), BARLETT COMPANY (\$000)

	For the years ended December 31	
	2015	2014
Sales revenue	\$3,074	\$2,567
Less: Cost of goods sold	<u>2,088</u>	<u>1,711</u>
Gross profits	\$ 986	\$ 856
Less: Operating expenses		
Selling expense	\$ 100	\$ 108
General and administrative expenses	194	187
Lease expense <sup>a</sup>	35	35
Depreciation expense	<u>239</u>	<u>223</u>
Total operating expense	\$ 568	\$ 553
Operating profits	\$ 418	\$ 303
Less: Interest expense	<u>93</u>	<u>91</u>
Net profits before taxes	\$ 325	\$ 212
Less: Taxes	<u>94</u>	<u>64</u>
Net profits after taxes	\$ 231	\$ 148
Less: Preferred stock dividends	<u>10</u>	<u>10</u>
Earnings available for common stockholders	\$ 221	\$ 138
Earnings per share (EPS) <sup>b</sup>	\$2.90	\$1.81
Dividend per share (DPS) <sup>c</sup>	\$1.29	\$0.75

<sup>a</sup>Lease expense is shown here as a separate item rather than being included as part of interest expense as specified by the FASB for financial reporting purposes. The approach used here is consistent with tax reporting rather than financial reporting procedures.

<sup>b</sup>Calculated by dividing the earnings available for common stockholders by the number of shares of common stock outstanding: 76,262 in 2015 and 76,244 in 2014. Earnings per share in 2015:  $\$221,000 \div 76,262 = \$2.90$ ; in 2014:  $\$138,000 \div 76,244 = \$1.81$ .

<sup>c</sup>Calculated by dividing the dollar amount of dividends paid to common stockholders by the number of shares of common stock outstanding. Dividends per share in 2015:  $\$98,000 \div 76,262 = \$1.29$ ; in 2014:  $\$57,183 \div 76,244 = \$0.75$ .

# Income Statement

Also called the statement of earnings

- Presents a firm's:
  - revenues
  - expenses
  - net income
  - earnings per share

... İşletmesi 01.01.20xx – 31.12.20xx Tarihli Gelir Tablosu
Net Satışlar ( <i>Net Sales / Net Revenue</i> )
Satışların Maliyeti (-) ( <i>Costs of Goods Sold – COGS</i> )
<b>Brüt Satış Kar / Zararı (<i>Gross Profit</i>)</b>
Faaliyet Giderleri (-) ( <i>Operating Expenses</i> )
<b>Faaliyet Kar / Zararı (<i>Earnings before Interest and Taxes - EBIT</i>)</b>
Diğer Faaliyetlerden Gelir ve Karlar
Diğer Faaliyetlerden Gider ve Zararlar (-)
Finansman Giderleri (-) ( <i>Interest Expenses</i> )
<b>Vergi Öncesi Kar (<i>Earnings before taxes</i>)</b>
Vergi (-) ( <i>Taxes</i> )
<b>Dönem Net Kar / Zararı (<i>Net profit / net loss</i>)</b>

# Net Sales

- Total sales revenue is shown net of returns and allowances.
- A sales return is a cancellation of a sale.
- A sales allowance is a deduction from the original sales invoice price.
- Sales are the major revenue source for most companies.
- $\text{Net sales} = \text{Gross Sales} - (\text{sales return or sales allowances})$

# Costs of Goods Sold (COGS)

Also called cost of sales

- Cost to seller of products or services sold to customers
- Affected by cost flow assumption used to value inventory
- Largest expense for many firms

# Gross Profit

- Also called gross margin
- Difference between net sales and cost of goods sold
- First step of profit measurement on the multi-step income statement
- Key analytical tool in assessing operating performance

# Operating Expense

- Includes areas in which management discretion is exercised
- Has considerable impact on current and future profitability
- Important to track trends, absolute amounts, relationship to sales, and relationship to industry competitors
  - *Selling and administrative expenses*
  - *Advertising costs*
  - *Depreciation and amortization*
  - *Repairs and maintenance*
  - *Impairment charges*

# Operating Expenses

## Operating Expenses – Selling and Administrative Expenses

- Relate to the sale of products or services
- Salaries, rent, insurance, utilities, supplies, etc.

## Advertising Costs

Are or should be a major expense when marketing is an important element of success



# Depreciation & Amortization

- Cost of assets other than land that will benefit a business enterprise for more than a year is allocated over the asset's service life.
- Cost allocation procedure is determined by the nature of the long-lived asset.
- Depreciation is used to allocate the cost of tangible fixed assets, such as:
  - buildings
  - machinery
  - equipment
  - furniture and fixtures
  - motor vehicles

# Operating Profit (EBIT)

- Also called Earnings Before Interest and Taxes (EBIT)
- Second step of profit determination on the multi-step income statement
- Measures overall performance of operations
- Provides a basis for assessing success of a firm apart from financing and investing activities and separate from tax considerations
- Sales revenue less the expenses associated with generating sales

# Other Income (Expense)

- Revenues and costs other than from operations, such as:
  - dividend and interest income
  - interest expense
  - investment gains (losses)
  - equity earnings (loss)
  - gains (losses) from sale of fixed assets

# Net Earnings /Net Profit

## *Net Earnings*

- Also called the “bottom line”
- Represents profit after consideration of all revenue and expense

## *Net Profit Margin*

Ratio of net earnings to net sales (expressed as a percentage)

Shows the percentage of profit earned on every sales dollar

## Earnings per Common Share (EPS)

- Net earnings available to common stockholders for the period divided by the average number of common stock shares outstanding
- Firms with complex capital structure report basic and diluted earnings per common share.

A firm's income statement included the following data.

- The firm's average tax rate was 20%.
- Costs of goods sold \$8,000
- Income taxes paid 2,000
- Administrative expenses 2,000
- Depreciation expense 1,000
- Selling expense 1,000
- Interest expense 1,000

What was the firm's net income?

What must have been the firm's revenues?

## EX 2 – BLACK INC.

	2018	2019
Revenue	\$4,000	\$4,100
Costs of goods sold	1,600	1,700
Depreciation	500	520
Inventories	300	350
Administrative expenses	500	550
Interest expense	150	150
Taxes	400	420
Accounts payable	300	350
Accounts receivable	400	450
Net fixed assets	5,000	5,800
Long-term debt	2,000	2,400
Notes payable	1,000	600
Dividends paid	410	410
Cash and marketable securities	800	300

## EX 2 – BLACK INC.

- ***Construct a balance sheet*** for Black Inc, for 2018 and 2019. ***What is shareholder's equity?***
- ***Construct an income statement*** for Black Inc, for 2018 and 2019
- Suppose that Black Inc, has 500.000 shares outstanding. ***What were Earnings per Share (EPS)?***