Analyzing Financing Activities

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How do financing decisions affect the financial statements ❓

1. Financing liabilities
2. Leases
3. Contingent liabilities and commitments
4. Off-balance-sheet financing
5. Equity financing

1. Financing liabilities

1. Financing liabilities

1.1 Types of Liabilities

Our analysis starts distinguishing between two types of liabilities:

A. 💰 Financing liabilities: all forms of credit financing, such as bank loans, bonds, and leases.

B. 📃 Operating liabilities: obligations that arise from normal business operations, such as accounts payable, accrued expenses, and taxes payable.

Of course, by traditional reporting purposes, liabilities are also classified as current or noncurrent, based on whether the obligation is expected to be satisfied within one year or the operating cycle, whichever is longer.

Let's start by focusing on financing liabilities.

One could take the numbers from the financial statements and compute solvency ratios. Or consider key information from:

The Notes:

- Interest rates, maturity dates, conversion privileges, and redemption clauses.

The Managerial report:

- Expectation of refinancing, debt covenants getting tight, and future financing needs.

The business press:

Bloomberg US E

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Markets

Apple Sells $5.5 Billion of Bonds to Fund Buybacks, Dividends

- 40-year security yields 118 basis points over Treasuries
- Company received highest possible credit rating in December

With this additional information we can work on different scenarios:

- Refinancing: what is the current cost of refinancing? Worse? Better? How much?
- Debt reduction: does the firm have enough cash? Issuing new shares? Selling assets?

Once we have a better picture of how the debt structure would look in the near future, we can include the respective adjustments in the financial statements before jumping into the ratios.

- This is especially true when the last report available is from many months ago.

Appendix: How does new debt impact the financial statements?

🔎 Example Apple 2020 [10 min]

(Remember: class participation: 20% final grade 😉)

1. Search liabilities in the balance sheet.
   - Here we just have very aggregated values.
2. Search: "Note 6-Debt" and "DESCRIPTION OF DEBT SECURITIES":

Get the following information: type of instruments, maturities, interest rates, ranking/seniority, redemption, and covenants.

- How is the debt distributed (maturity, type of instrument)?
- What are the interest rates in these debt contracts? How is the market now?
- Is any big maturity coming up soon? News from rolling over?

ECONOMY

Corporate bankruptcies and defaults are surging – here's why

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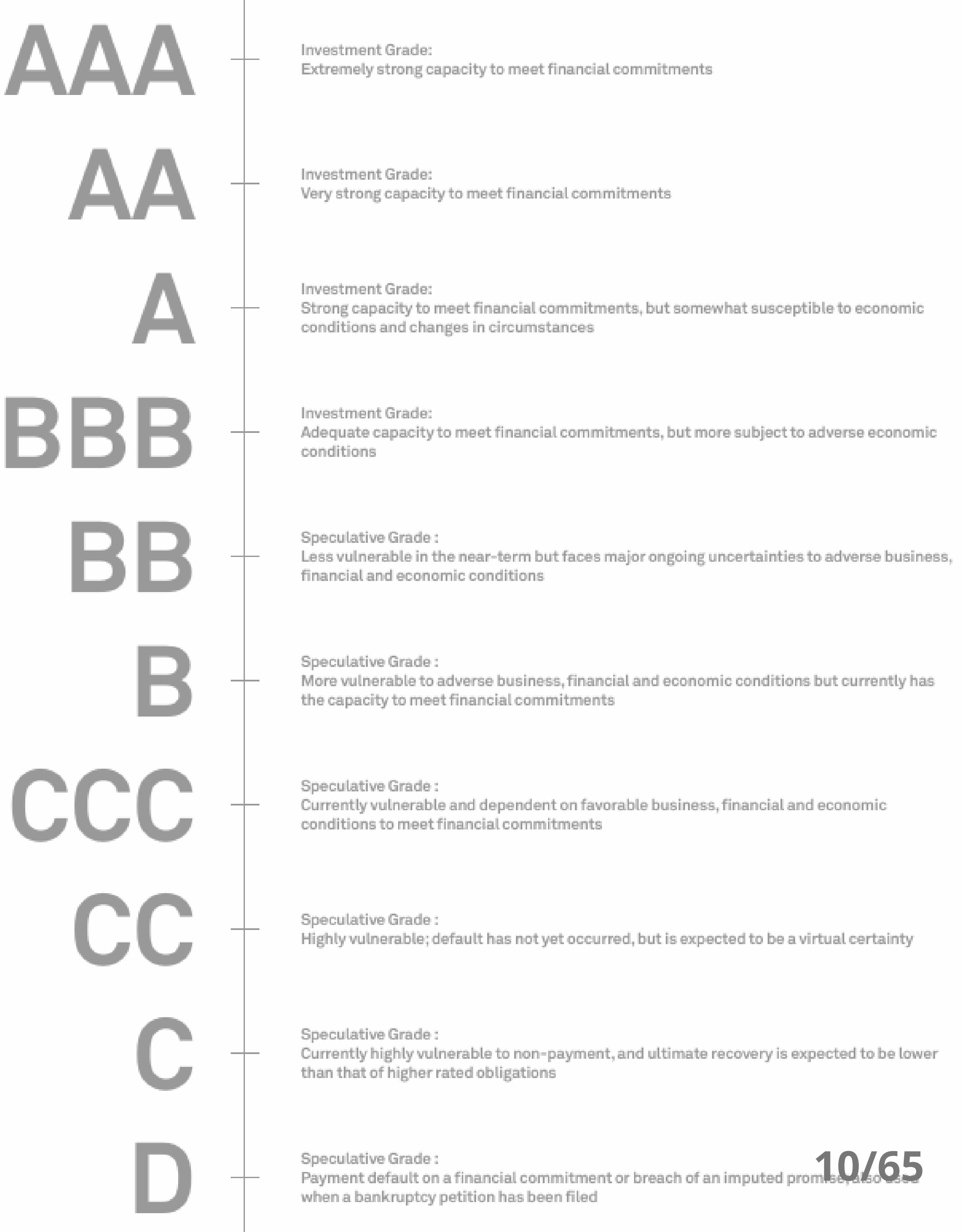
KEY POINTS

- Corporate defaults rose last month, with 41 in the U.S. so far this year. That's more than double the same period last year, according to Moody's Investors Service.
- Companies are defaulting on their debt due to uncertain economic conditions and heavy debt loads. High interest rates have made it difficult to refinance, as debt is more expensive.

Credit Ratings

The credit rating of a bond is an assessment of the issuer's ability to make timely payments of interest and principal.

S&P



Bond valuation and credit ratings

Therefore, it is not surprising that the credit rating of a bond is a major determinant of

1. the interest rate that the issuer must pay to sell the bond.
2. the fair value of the issued bonds in the market.

2. Leases

2. Leases

Now we move into operating liabilities ground.

2.1 Definitions and key elements

- It is a contractual agreement between a **lessor** (owner) and a **lessee** (user) that gives the lessee the right to use an asset owned by the lessor for a specified period of time in exchange for periodic payments.

Contracting terms:

- Minimum lease payments (MLP), or Based Rent, are the fixed payments that the lessee is obligated to make over the lease term.
- Contingent rentals are payments that depend on the future performance of the leased asset.
    - Mileage for a car lease, sales performance for a retail store lease, etc.
- Residual value guarantees are guarantees that the lessee will pay the lessor a specified amount at the end of the lease term if the residual value of the leased asset is less than the guaranteed amount.

2.2 Capital vs. Operating Leases

- Capital lease: substantial transference of all the benefits and risks of ownership to the lessee.
  - Recognition of a new asset (*right-of-use asset*) and liability.
- Operating lease: all other leases.
  - Recognizing just rental expenses.

Strong incentive to structure leases as operating leases even when they are economically equivalent to capital leases.

- Operating leases are not reported on the balance sheet.
- Off-balance-sheet financing.
- Tax considerations.

An illustrative example

- A company leases an asset on January 1, 2005.
- The company has no other assets or liabilities.
- The estimated economic life of the leased asset is 5 years and no residual value is expected.
- The lease has a fixed noncancelable term of 5 years with MLP of $2,505 per year, payable at the end of each year. The interest rate on the lease is 8% per year.
- Depreciation is computed using the straight-line method.

First, let's compute the present value of the MLP. Remember that the PV of an annuity is given by $P_0 = \frac{1-1/(1+i)^n}{i}$. In this case, $i = 8\%$ and $n = 5$.

- $P_0 = \frac{1-1/(1.08)^5}{0.08} = \mathbf{3.9927}$
- Leased asset value = $\mathbf{\$2.505 \times 3.9927 = 10.000}$

Second, compute the interest expense and depreciation expense for each year.

Year	Op. Lease (Rental exp.)	Interest exp.	Dep. exp.	Cap. Lease
2005	$2,505	$800	$2,000	$2,800
2006	2,505	664	2,000	2,664
2007	2,505	517	2,000	2,517
2008	2,505	358	2,000	2,358
2009	2,505	186	2,000	2,186
Total	12,525	2,525	10,000	12,525

Total expense is identical for both cases, but the timing is different: capital lease reports more expenses earlier 📈 🆚 📉

But more importantly: the operating lease does not report any liability (nor asset) in the balance sheet.

2.4 Capital lease criteria

A lease is classified as a capital lease if any of the following conditions are met:

1. Ownership of the asset is transferred to the lessee at the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to 75% or more of the estimated economic life of the leased asset.
4. The present value of the minimum lease payments is equal to 90% or more of the fair value of the leased asset.

2.5 Reporting

- Capital lease: the lessee recognizes an asset and a liability at the present value of the MLP.
- Furthermore, lessees have to report leased assets and lease liability for all leases (operating and capital) with a term of more than 12 months.
- We can find the information in two places:
  - "Significant/Selected Accounting Policies"->"Leases"
  - "Notes to the Financial Statements"->"Leases"

🔎 Example Apple 2020 [5 min]

Search: "Note 12- Leases"

1. Identify the type of assets being leased.
2. Identify where the lease asset and the lease liability are reported.
3. What fraction of lease agreements are capital/finance vs operating leases?
4. Identify the lease maturity schedule.

🔎 Example: Colgate-Palmolive 2022

> ## 15. Leases.
>
> Substantially all of the Company’s leases are considered operating leases. Finance leases were not material as of December 31, 2022, and 2021.

Lease liabilities for operating leases as of December 31, 2022 were as follows:

2023	$	124
2024		88
2025		69
2026		54
2027		50
Thereafter		201
Total lease commitments	$	586
Less: Interest		(81)
Present value of lease liabilities	$	505

🔎 Example: Grifols 2022

Operating Leases - Lessee

At 31 December 2022 and 2021, the Company has contracted various office premises and a plot of land under operati leases from third parties and one related party.

The most significant lease contracts are as follows:

Contract with a related party for offices located in Sant Cugat del Vallès (Barcelona) (SC1+SC2+SC3+SC4+SC5)

The contracts period is until 1st March 2040 and it is of compulsory compliance (until 9th February 2040, for SC with five-year tacit renewals. They may be cancelled by giving notice of 6 months in advance.

Contract with a group company for industrial buildings located in Parets del Vallès (Barcelona) (P4)

This contract is valid until 10th May 2026 and it is of compulsory compliance, with five-year tacit renewals, unl either of the parties cancels the contract giving notice of 6 months in advance after fulfilling the compulsory period

Contract with a group company for the plot in Parets del Vallès (Barcelona) where the construction of buildings P and P13 is located

This contract is valid until 10th May 2026 and it is of compulsory compliance, with five-year tacit renewals, unl either of the parties cancels the contract giving notice of 6 months in advance after fulfilling the compulsory period

Operating lease payments have been recognised as an expense for the year as follows:

	Thousand Euros	
	2022	2021
Lease payments (recognised as an expense)	11,164	9,76

Future minimum payments under non-cancellable operating leases are as follows:

	Thousand Euros	
	2022	2021
Less than one year	11,548	9,86
One to five years	35,212	32,64
Over five years	76,831	63,95
	123,591	106,46

2.6 Impact of Operating Leases on Financial Statements

1. Understate liabilities by keeping lease obligations out of the balance sheet. Impact solvency ratios.
2. Understate assets, inflating return on investment and assets turnover ratios.
3. Delay the recognition of expenses, inflating net income and EPS.

Now it should be clear why operating leases are so popular: it positively affects key ratios that are used by investors and creditors to assess the financial health of the company.

2.7 Converting Operating Leases to Capital Leases

Many analysts and investors try to convert operating leases to capital leases to assess the impact of operating leases on financial statements.

Suggestions: classify only when the lessee's classification appears inconsistent with the economic characteristics of the lease.

The following method provides reasonable estimates of the impact of operating leases on the financial statements, but it does not precisely quantify all the effects of the lease reclassification.

Data from the 2022 annual report of Colgate-Palmolive.

Estimate the length of the remaining period beyond the 5 years disclose in the Notes: $\$201/50 = 4.02$ years.

Add this length to the 5 years of the 2023-leases: 9.02 years.

Many would argue that a 9-year commitment for operating leases is too long to ignore.

So, we need to evaluate how much the financial statements would change if we capitalize on the operating leases.

Let's do it in MS Excel.

1. Estimate interest rate to discount projected lease payments.
    - Trial and error: the interest rate that matches the PV of the MLP and the projected lease payments. Both are disclosed in the Notes.
2. Add the PV of the MLP to the balance sheet as a liability.
    - Identify the short and long-term portions of the liability.
3. Estimate the value of the operating lease asset.
    - Here more complications arise: economic life, depreciation policy, residual value, etc.
    - For simplicity, we assume that its value equals the PV of the MLP (liability).
4. Income statement: Compute the interest expense and depreciation expense for each year.

Conclusion: No red flags.

- Income statements: in case of a change of criteria, future operating expenses would increase just 10 USD million, less than 1% of the net income in 2022.
- Total assets = $15,731, adj lease asset ($505): 3.2% of total assets.
- Total liabilities = $14,925, adj lease liability ($505): 3.4% of total liabilities.
    - Not a problem per se in the current situation:
        - Debt-to-Assets ratio=0.55
        - Current ratio=1.27.

3. Commitments and contingent liabilities

3. Commitments and contingent liabilities

3.1 Contingent liabilities

A contingent liability is a potential loss that depends on some future event such as litigation, threats of expropriation, product warranties, etc.

Conditions for recognizing a contingent loss in the balance sheet:

1. Probable Occurrence: The future event that would trigger the loss is more likely than not to occur.
2. Reasonable Estimation: The amount of the loss can be reasonably estimated.

In other cases the disclosure without recognition may be required.

The company must disclose the contingency in the Notes when there is at least a *reasonable possibility* that a loss will occur.

Reported contingent liabilities are based on the company's estimates.

- Prior experience or future expectations.

Our analysis, then, is limited by the quality of these estimates.

Note disclosure should include the following information about contingencies:

1. Nature of the contingency.
2. Degree of uncertainty about the outcome.
3. The possible range of loss.

Of course, it is reasonable to assume that companies will disclose only the information that is favorable to them.

Typical examples of contingent liabilities:

- Litigation: lawsuits, claims, and assessments.

3.2 Commitments

A commitment is a potential claim against a company's resources that depends on some future event under contract.

Frequent commitments:

- Purchase commitments
- Debt covenant restrictions
- Licensing agreements

🔎 Example Apple 2020 [5 min]

Search: Balance sheet "Commitments and Contingencies."

Search: "Note 10 – Commitments and Contingencies."

1. Identify the type of commitments.
   - How much are the accrued warranties? Iphone upgrade program as a guarantee liability.
   - What are the Unconditional Purchase Obligations? Compare the amount to debt or total liability.
2. What is the most common type of contingent liabilities? Is any of them material?

🔎 Example: Grifols 2022

(18) Other Provisions, Other Guarantees with Third Parties and Other Contingent Liabilities

(a) Contingencies

Contingent liabilities for bank and other guarantees are disclosed in Note 20. The Company does not expect any significant liabilities to arise from these guarantees.

(b) Commitments with employees

In the event of a takeover, the Company has agreements with 19 employees/directors whereby they can unilaterally rescind their employment contracts with the Company and are entitled to termination benefits ranging from two to five years' salary.

The Company has three contracts with 4 members of Senior management who will receive a termination benefit ranging from one to two years' salary, depending on the circumstances.

4. Off-balance-sheet financing

4. Off-balance-sheet financing

It refers to the non-recognition of financing activities in the financial statements.

- Operating leases are the most common example.
- Other examples: special purpose entities, joint ventures, limited partnerships, etc.

4.1 Joint ventures

A joint venture is a business entity created by two or more parties, generally characterized by shared ownership, shared returns and risks, and shared governance.

Steps for hiding debt (don't do it!)

1. The company creates a separate entity and provides financing *not exceeding 50%* of the total capital.
    - The company does not consolidate the joint venture: it is treated as an investment.
2. The separate entity borrows money from a bank and uses the money to purchase assets.
3. The separate entity leases the assets to the company.

4.2 Special purpose entities (SPEs)

A special purpose entity (SPE) is a legal entity created to fulfill narrow, specific or temporary objectives.

- Typically used by companies to isolate the firm from financial risk.
- And for accounting fraud 💣

Steps for hiding debt (don't do it!)

1. The company, called the *sponsor*, forms a separate entity and capitalizes it with equity investment, some of which must be from independent third parties.
2. The SPE issues debt and uses the proceeds to purchase earnings assets from or for the sponsoring company.
3. The cash flow from the earnings assets is used to pay the debt and provide a return to the equity investors.

Example 1 Securitization of receivables:

Steps:

1. Companies sell their receivables to SPEs, which issue debt to finance the purchase.
   - ⏬ Receivables and ⏫ Cash
2. SPE issues collateralized bonds with the receivables.
3. SPE sells the bonds to investors; the proceeds are used to purchase more receivables on an ongoing basis.

Example 2 Commitments to purchase assets: A company needs to fund the construction of a manufacturing plant.

Steps:

1. Companies execute a contract with the SPE to purchase the output of a plant.
2. The SPE issues debt to finance the construction of the plant
    - collateral: contract and the property
3. SPE funds the construction of the plant with the debt proceeds.

The company obtains the benefit of the plant without recording the debt on its balance sheet.

Why SPEs are so popular ❓

1. They allow companies to obtain lower-cost financing.

- As SPEs are restricted to a single purpose, they are less risky than the sponsoring company.

2. They allow companies to avoid violating debt covenants.

- If structured properly, the SPE is not consolidated in the sponsoring company's financial statements.

Reporting of Joint Ventures and SPEs:

- Very limited information in the annual reports:
  - Check Apple 2020: "Exhibit 21.1"
  - Check Inditex 2022: "Appendix 1: Composition of the Inditex Group".
  - Check Grifols 2022: "Appendix II: Classification of financial assets by category".
- In practice, it is more common to rely on specialized business databases like Orbis or Capital IQ.

🔎 Example: Colgate-Palmolive 2022

> **Off-Balance Sheet Arrangements**
>
> The Company does not have off-balance sheet financing or unconsolidated special purpose entities.

5. Equity financing

5. Equity financing

Equity refers to the owners' (shareholders') financing of a company

Commonly viewed as reflecting the claims of owners against the assets of the company.

Typically, holders of equity securities are subordinate to creditors in the event of liquidation.

5.1 Capital stock

The capital stock is also known as "share capital," "equity capital," or "paid-up capital."

The capital stock is the total amount of equity capital that a company raises by issuing and selling its shares of common and preferred stock to investors.

Components of capital stock

1. Contributed capital:
    - One part is assigned to the par or stated value of capital shares: Common and/or Preferred stock
    - The remainder is reported as additional paid-in capital (APIC)
        - e.g., company issues 1 million common shares, par value $1, means that the company has raised $1 million in capital stock.
        - at closing date: share price=$1.5 => APIC=$500,000

2. Treasury stock (buybacks)
    - The amount of capital stock repurchased by the company and kept in their own treasury. Why? as an attempt to increase the share price or limiting dilution.
    - It reduces both contributed assets and total equity (*contra-equity account*).
    - Recorded at cost value.

3. Retained earnings: accumulated earnings of the company that have not been distributed to shareholders as dividends.
    - Covenants can create restrictions on the use of retained earnings (check Bond indentures and Loan agreements).
4. Other comprehensive income (OCI): unrealized gain and losses not recognized in the income statement.
5. Noncontrolling interest (NCI): equity interest in a subsidiary not attributable to the parent company.

Classification of capital stock

1. Preferred stock
    - dividend distribution preferences (usually fixed)
    - liquidation priority
    - convertibility into common stock
    - non or limited voting rights
2. Common stock
    - voting rights
    - bear the residual risk and rewards of the company

Example: First year of operations: ¿What is the total equity of the company?

	Total equity
Common shares	
# shares outstanding = 100,000	
Par value = $5	Common share capital (at par)=$500,000
Issuance price = $8.5	APIC: $350,000
Preferred shares	
# shares outstanding = 20,000	
Par value = $10	Preferred share capital (at par)=$200,000
Net income = $1,150,000	Ret. earnings = $1,150,000
OCI: $300,000	OCI: $300,000
Dividends = $450,000	Dividends = -$450,000
Treasury stock = $50,000	Treasury stock = -$50,000
Total	$2,000,000

🔎 Example: Apple 2022

DESCRIPTION OF COMMON STOCK

The following is a description of the rights of Common Stock and related provisions of the Company's Restated Articles of Incorporation (the "Articles") and Amended and Restated Bylaws (the "Bylaws") and applicable California law. This description is qualified in its entirety by, and should be read in conjunction with, the Articles, Bylaws and applicable California law.

Authorized Capital Stock

The Company's authorized capital stock consists of 50,400,000,000 shares of Common Stock.

Common Stock

Fully Paid and Nonassessable

All of the outstanding shares of the Company's Common Stock are fully paid and nonassessable.

Voting Rights

The holders of shares of Common Stock are entitled to one vote per share on all matters to be voted on by such holders. Holders of shares of Common Stock are not entitled to cumulative voting rights.

Except as described below or as required by law, all matters to be voted on by shareholders must be approved by the affirmative vote of (i) a majority of the shares present or represented by proxy and voting and (ii) a majority of the shares required to constitute a quorum.

🔎 Example: Inditex 2022

24. Equity

Share capital

At 31 January 2023 and 2022, the Company's share capital amounted to 94 million euros, and was divided into 3,116,652,000 fully subscribed and paid shares of 0.03 euros par value each. All the shares are of a single class and series, carry the same voting and dividend rights.

🔎 Example: Grifols 2022

(17) Equity

Details of equity and movement during the year are shown in the statement of changes in equity.

(a) Capital

At 31 December 2022 and 2021 the share capital of Grifols S.A. amounts to Euros 119,603,705 and is represented by:

- Class A shares: 426,129,798 ordinary shares of Euros 0.25 par value each, subscribed and fully paid and of the same class and series, and which are ordinary shares of the Company.
- Class B shares: 261,425,110 non-voting preference shares of Euros 0.05 par value each, of the same class and series, and with the preferential rights set forth in the Company's by-laws.

Our focus: can we foresee capital stock dilution ❓

Common variations in the capital stock:

- issuance of new stocks
- repurchase of stocks
- conversion of debentures and preferred stocks

Less common reasons to keep in mind:

- Stock options with compensation and bonus plans calling for the issuance of capital stock over some time at fixed prices (i.e., employee stock ownership plan)
- Commitments to issue capital stock in the future (i.e., stock warrants, or merger agreements)

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U.S. Markets

Factbox: U.S. stock buybacks so far in 2023: big money, fewer companies

Reuters

February 7, 2023 12:25 PM GMT+1 · Updated 7 months ago

Aa

> - S&P 500 companies are expected to have completed $220 billion in buybacks during the fourth quarter of 2022, according to S&P Dow Jones Indices. [...]

> - 2023 should be the first fiscal year with at least $1 trillion in completed S&P 500 company buybacks, according to Howard Silverblatt, senior index analyst at S&P Dow Jones Indices.

Based on:

- Subramanyam, K. R. (2014). Financial statement analysis. McGraw-Hill Education. Chapter 3.
- Steven M. Bragg (2022). IFRS Guidebook. Accounting Tools. Chapters 19 and 29.
- IFRS 16 Leases
- IAS 37 Provisions (IFRS) Contingent Liabilities and Contingent Assets
- IFRS 11 Joint Arrangements

Questions ❓

Check my website for an updated version of this presentation:

👉 https://www.marceloortizm.com/

Thanks 👏

Appendix

Financial Debt: accounting and reporting

January 1. Assume you created a new company with 10,000 euros in share capital. Then, you obtain a €10,000 loan with €1,000 interest, to be repaid in a lump sum in 13 months. How will your financial statements be affected?

At the moment of getting the loan:

	Effect
1) Balance Sheet	Cash: +10,000
	Bank Loan: +10,000
2) Income Statement	No Impact
3) CF Statement	Financing act: +10,000

At the end of the year (*ceteris paribus*):

	Effect
1) Balance Sheet	Cash: no changes (10,000)
	Bank Loan: no changes (10,000)
	Interest payable: +923.08 (=1,000 x (12/13)
2) Income Statement	Interest exp: +923.08
3) CF Statement	Financing act: no changes (10,000)

After paying the loan (*ceteris paribus*):

	Effect
1) Balance Sheet	Cash: -11,000
	Bank Loan: -10,000
	Interest payable: -1,000
2) Income Statement	Interest exp: +76,92
3) CF Statement	Financing act: -11,000

IFRS vs. US GAAP: classification of interest and dividends in the CF statement

	US GAAP	IFRS
interest paid	Operating	Operating or Financing
dividend paid	Financing	Operating or Financing
interest received	Operating	Operating or Financing
dividend received	Operating	Operating or Financing