Accounting for Financial Decision
EMBA
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(KUSOM)

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Steps: Revision in earlier plan

- Teaching order:
  - Identify and critically evaluate the ***responsibilities of directors*** in relation to governance and internal control.
  - Understand accounting and financial methods i.e., **Income statement, Balance sheet, Cash flow**.
  - Use of ***financial ratios*** to critically analyze and interpret a set of published financial statements.
  - Understand the implication of ***regulatory requirements*** and change in ***accounting standard***.
  - Assess ***cost, price and budget*** based on accounting data to support organizational objectives.

Expectation: Background in Accounting (General Entries)

Now (after assessment): 1 week for basic entries + Other Fin. Statements

Group Project: we follow chronological order

A: Performance Ratios and Chairman statement: Total Score out of 60	GrP
1. Clear evidence of how calculations completed, as suggested in the assessment guidelines. (score out of 15)	
2. Explanations & comments. (score out of 20)	
3. Other additional ratios and comment (score out of 10)	
4. Critical analysis of Chairman statements (score out of 15)	

B: Corporate Governance: Total Score out of 20	GrP
1. Clear discussion on corporate governance (score out of 10)	
2. Reasons and explanation for noncompliance with the CG codes (score out of 10)	

C: Sensitivity and Financial Health: Total Score out of 20	GrP
1.Calculation and discussion of sensitivity analysis (score out of 10)	
2.Estimation and explanation of F- score and Z-score (score out of 10)	

Overview of Financial and Accounting Environment

Accounting to Financial Statement Analysis

- **Accounting is** a systematic process that is concerned with ***measurement and reporting*** of transactions and events occurring in an organization.

*Mastering accounting is like mastering many subjects: First, you must understand the lingo and the fundamentals.

*We cover only basic accounting (You need to revise as suggested)

https://www.accountingcoach.com/debits-and-credits/outline

Accounting to Financial Statement Analysis- 1st

- All organizations, irrespective of the legal status – proprietorship, partnership, incorporated company, statutory corporation or trust and whether they exist for profit or not for profit, are formed with a view to achieve certain goals (**objective, purpose or vision as you may choose**).

- In order to impart direction and greater certitude to achieving the result, organizations prepare plans. It is said that all plans, in order to succeed, have to be controlled and all controls, in order to be effective, have to be planned. This implies that the ***actual performance should be measured, compared with the plans and deviation suitably dealt with***. The action taken may involve either correcting the performance or modifying plans or both.

- ***Why ?-*** *Strategic Decision (Investment Decision, Financing options..)*

Accounting to Financial Statement Analysis- 2nd

- There are ***several stakeholders*** of business who will need financial information for decision making. For this purpose, organizations have to measure the performance, and this is achieved through the accounting system.

- The objective of financial accounting is to provide ***relevant, reliable and timely information for decision making.***

- ***Other stakeholders' examples (why):*** *Customers (Supply), Creditors (Receivables), Employees (Salary and Bonuses), Lender (Interest and Principles), Government (Tax),* ***Investors (Return)***

Financial Statement Analysis to **forecast**

- ***Why do investor analyze financial statement***?
  - To make a decision (stakeholders' requirement).
  - Understand firm's future prospects (for which forecasting is needed).

- Forecast: But what?

  Let's assume from managers' angle (**Increase market share/ SW maximization**)

  - e.g., Revenue: All others are tied up with revenue (Table).
  - Accounting information: Ratio analysis (Vertical and Horizontal)
  - Cash flow analysis: Valuation Models (Covered in final semester: Corporate finance)

Financial Statement Analysis- Sources

- Accounting disclosures:
  - Income Statement
  - Balance Sheet
  - Cash flow
  - Statement of changes in owner's equity
- Chairman statement, CEO statement, Risk analysis
- Top- down approach: Economy –Industry- Company Analysis
- SWOT Analysis
- Lifecycle Analysis

Financial Statement Analysis- Sources

Chairman statement, CEO statement, Risk analysis (***Not an exhaustive list***)

- Information about firm performance
- Missed target (if any)
- Future plans
- Others….

Highlights corporate activities, strategies, researches, labor relations, main achievements, focuses on future goals, growth (market share ?).

Financial Statement Analysis- Sources

Top- down approach: ***Economy*** –Industry- Company Analysis

- An **economic analysis** of regulatory or policy options **should** present all identifiable costs and benefits that are incremental to the regulation or policy under consideration. These **should include** directly intended effects and associated costs, as well as ancillary (or co-) benefits and costs (***Bank and change in reserve requirement/ Effect of recession/boom on debt***).
- Economic characteristics and competitive dynamics ***influences the strategies firms will employ***.
- Analyst should ***consider the economic characteristics and competitive dynamics*** while analyzing and forecasting financial statements.

Financial Statement Analysis- Sources

Top- down approach: Economy –***Industry***- Company Analysis

- Porter's Five Forces classification framework

  - Rivalry (Concentrated or Diffusion: Greater the industry concentration, the lower the competition between existing rivals and thus the more profitable the firms will be)

  - New Entrants (Entry barrier, easy to enter, proprietorship right)

  - Substitute products (Alternative available, loyalty)

  - Suppliers (Negotiation power)

  - Customers (Price taker or price setter)

Financial Statement Analysis- Sources

Top- down approach: Economy –Industry- ***Company Analysis***

- Framework for Strategy Analysis
  - Nature of product or service (Uniqueness, low-cost leadership)
  - Integration within value chain (Is the firm conducting all manufacturing operations itself, outsourcing all manufacturing, or outsourcing the manufacturing of components but conducting the assembly operation in-house?)
  - Geographical diversification (Is the firm targeting its products to its domestic market or integrating horizontally across many countries?)
  - Industry diversification (Is the firm operating in a single industry or diversifying across multiple industries?)

Financial Statement Analysis- Sources

SWOT Analysis

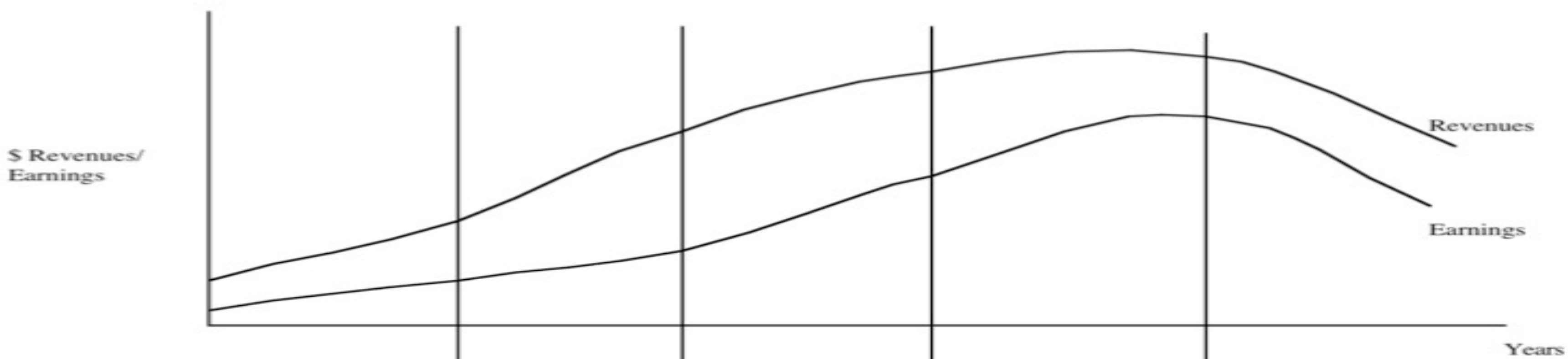
- A **SWOT analysis** is a compilation of your company's strengths, weaknesses, opportunities and threats. It helps organizations develop a full awareness of all the factors involved in making a business decision.

Strengths What do you do well? What unique resources can you draw on? What do others see as your strengths?	**Weaknesses** What could you improve? Where do you have fewer resources than others? What are others likely to see as weaknesses?
• We are able to respond very quickly as we have no red tape, and no need for higher management approval. • We are able to give really good customer care, as the current small amount of work means we have plenty of time to devote to customers. • Our lead consultant has a strong reputation in the market. • We can change direction quickly if we find that our marketing is not working. • We have low overheads, so we can offer good value to customers.	• Our company has little market presence or reputation. • We have a small staff, with a shallow skills base in many areas. • We are vulnerable to vital staff being sick or leaving. • Our cash flow will be unreliable in the early stages.
Opportunities What opportunities are open to you? What trends could you take advantage of? How can you turn your strengths into opportunities?	**Threats** What threats could harm you? What is your competition doing? What threats do your weaknesses expose to you?
• Our business sector is expanding, with many future opportunities for success. • Local government wants to encourage local businesses. • Our competitors may be slow to adopt new technologies.	• Developments in technology may change this market beyond our ability to adapt. • A small change in the focus of a large competitor might wipe out any market position we achieve.

Business Model & Life cycle of a firm: Why consider?

- Business Model: Financial Institutions v/s Others (**Valuation Models/ CF Stages**)
- Life Cycle of a Firm: Growth and Reinvestment (**Growth potential**)
- Dividend Payout (D/NI): **More than Income? Negative Didividend?**

Figure 10.7: Life Cycle Analysis of Dividend Policy



External funding needs	High, but constrained by infrastructure	High, relative to firm value.	Moderates, relative to firm value.	Low, as projects dry up.	Low, as projects dry up.	
Internal financing	Negative or low	Negative or low	Low, relative to funding needs	High, relative to funding needs	More than funding needs	
Capacity to pay dividends	None	None	Very low	Increasing	High	
Growth stage	Stage 1 Start-up	Stage 2 Rapid Expansion	Stage 3 High Growth	Stage 4 Mature Growth	Stage 5 Decline	Years

Financial Statement Analysis- Sources

- Income Statement: Reports financial performance of a firm (1 year)
  - Revenue: Sales of goods and services
  - Expenses: Cost incurred for producing goods or services
  - Net Income: Resulting profit or loss
  - Net Income = Revenue- Expenses (TABLE)

- Balance Sheet: Reports firm's financial position at a specific time
  - Assets: What company owns.
  - Liabilities: What company owes.
  - Owner's Equity: What the shareholder of the company owns
  - Assets = Liabilities + Owner's equity (TABLE)

- Cash flow statement: Reports the source and uses of cash
  - Operating cash flow: Cash flow from day-to-day activities.
  - Investing cash flow: Cash flow associated with acquisition of long term/fixed assets
  - Financing cash flow: Cash flow from obtaining or repaying capital

e.g., Sales – 10000 with cash 8000 and credit 2000

Financial Statement Analysis- Sources

- Statement of changes in owner's equity: Reports change in the owners' investment
  - Paid in capital: Amount raised from owners

  e.g., Fine payment: derive effect from equation: Assets = Liabilities + Owners Equity.

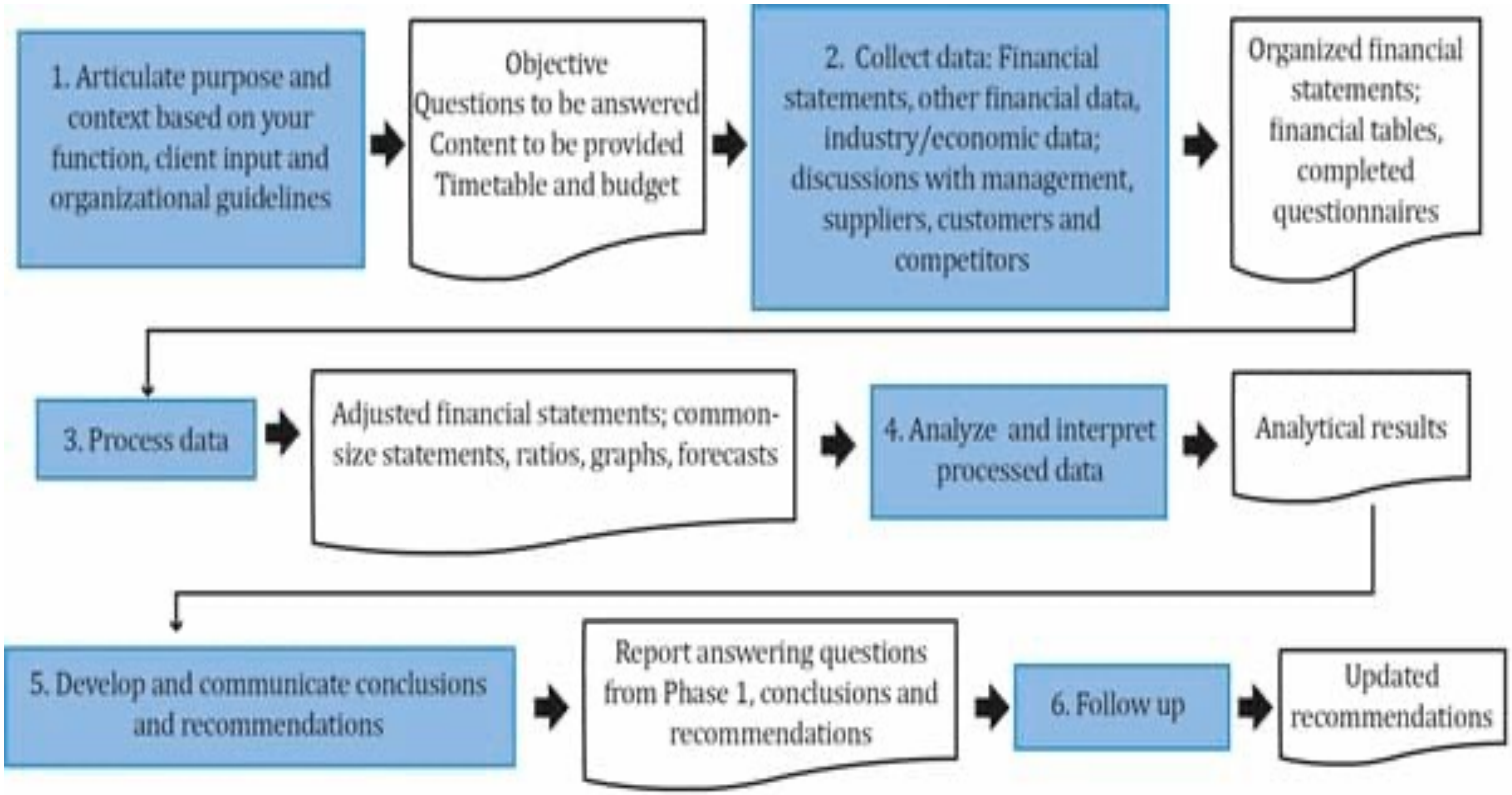
  - Retained earnings: Firm profit that have been retained (relation with dividend and growth)

  e.g., Earnings and dividend character (formula: ROE x (1- Div. payout)),

  future growth/ grab opportunity, return if no opportunity: buyback or cash

- Others:
  - Footnotes, Auditor's report. Press release, NEWS papers

Financial Statement Analysis-Process



Source: CFA website

Generic DCF Valuation Model: Inputs

- A publicly traded firm potentially has an infinite life. The value is therefore the present value of cash flows forever.

$$\text{Value} = \sum_{t=1}^{t=\infty} \frac{CF_t}{(1+r)^t}$$

- Since we cannot estimate cash flows forever, we estimate cash flows for a "growth period" and then estimate a terminal value, to capture the value at the end of the period:

$$\text{Value} = \sum_{t=1}^{t=N} \frac{CF_t}{(1+r)^t} + \frac{\text{Terminal Value}}{(1+r)^N}$$

- Practical: We have to stop forecasting cash flow and calculate terminal value at some point.

- **Sensitivity Analysis**

Angle: Firm or Investor ?

Value enhancement: CF, COC, Growth, TV ?

Practical Issues: each section ?

Firm Objective: Shareholder Wealth Maximization (Why?)

&

Make sure shareholders' interest is protected: Corporate Governance (How?)

Firm Objective: Shareholder Wealth Maximization (Why?)

The Firm: Structural set-up

- Finance is built on three principles, which we will call, rather unimaginatively, the investment principle, the financing principle, and the dividend principle.

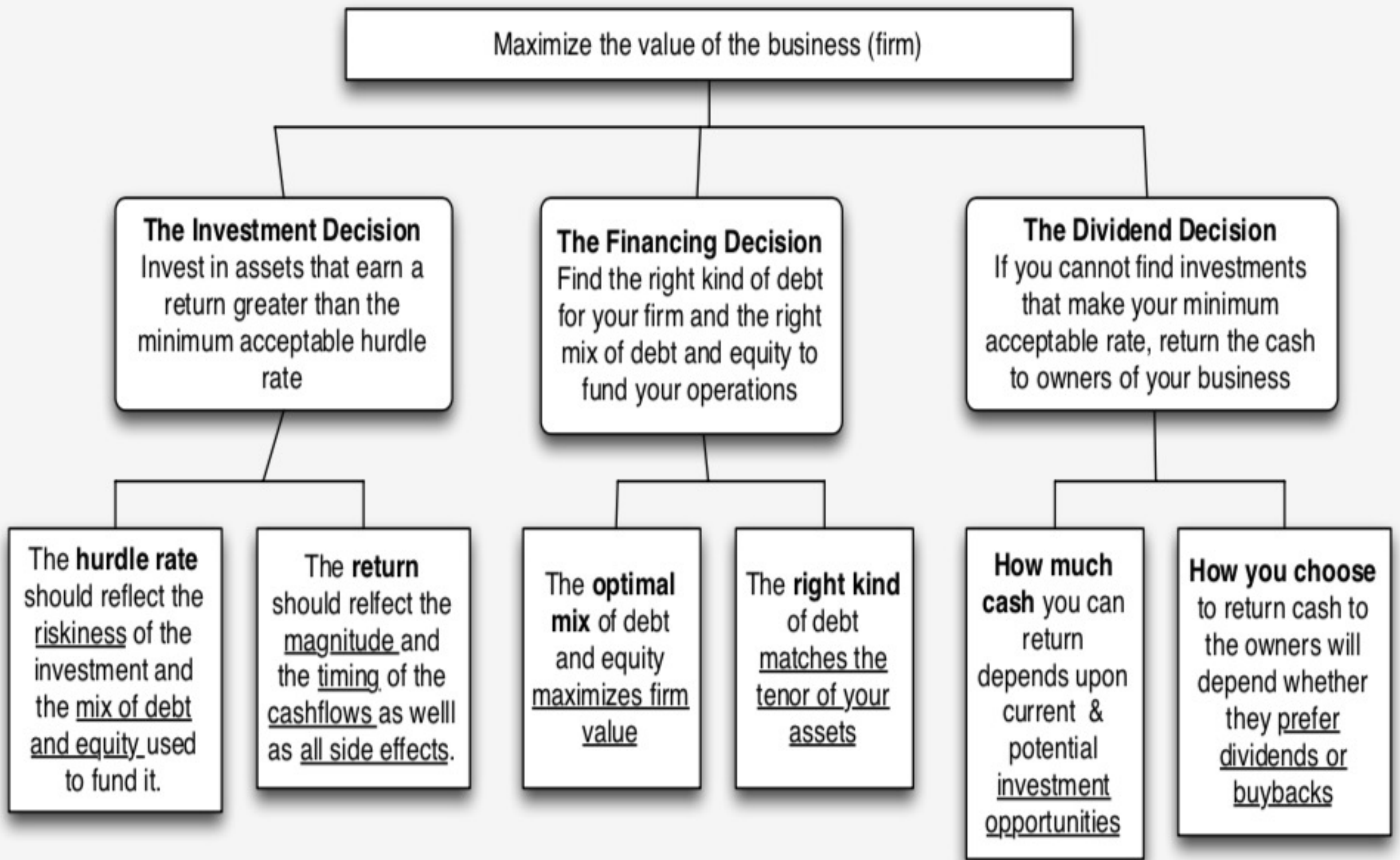
- The **investment principle** determines where businesses invest their resources, the **financing principle** governs the mix of funding used to fund these investments, and the **dividend principle** answers the question of how much earnings should be reinvested back into the business and how much returned to the owners of the business.

Main Principle of Finance

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners' funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the tenure of assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.

Objective: Maximize the Value of the Firm

Main Principle of Finance



Finance Decision: Logic

- Value Maximization: Gives corporate finance its focus. As a result of this singular objective, we can
  - Choose the “right” investment decision rule to use, given a menu of such rules.
  - Determine the “right” mix of debt and equity for a specific business
  - Examine the “right” amount of cash that should be returned to the owners of a business and the “right” amount to hold back as a cash balance.

Value Maximization : Issues

- In traditional corporate finance, the objective in decision making is to maximize the value of the firm.

- A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.

- All other goals (employ/ social/ environmental) of the firm are intermediate ones leading to firm value maximization **or** operate as constraints on firm value maximization.

Value Maximization : Arguments

- Maximizing stock price is <u>not incompatible with meeting employee needs/objectives</u>. In particular:
  - Employees are often stockholders in many firms
  - Firms that maximize stock price generally are firms that have treated employees well.

- Maximizing stock price <u>does not mean that customers are not critical to success.</u> In most businesses, keeping customers happy is the route to stock price maximization.

- Maximizing stock price <u>does not imply</u> that a company must be a <u>social outlaw.</u>

Traditional Financial Theory Focuses on Maximizing Stockholder Wealth: why?

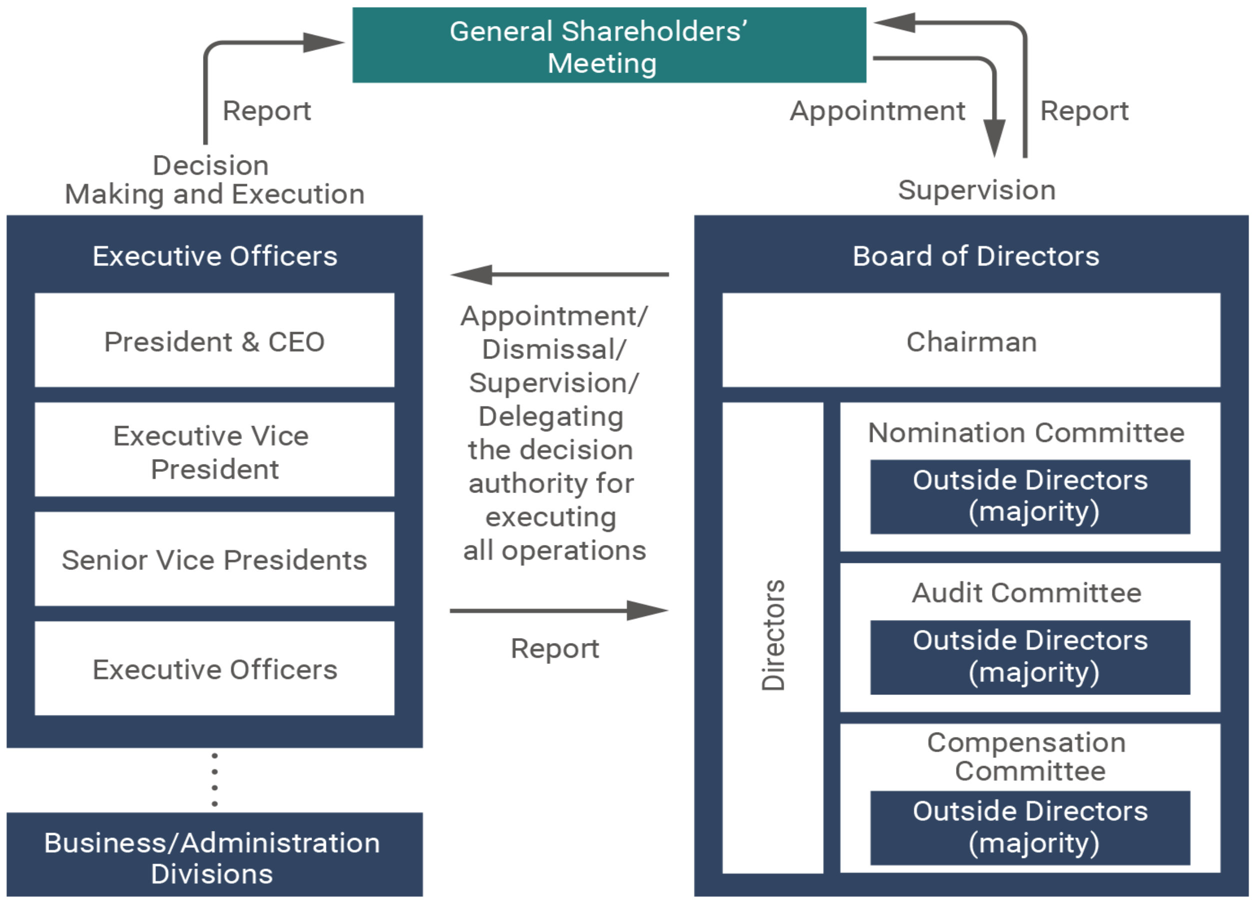
- Stock price is easily observable and constantly updated (unlike other measures of performance, which may not be as easily observable, and certainly not updated as frequently).

- If investors are rational (are they?), stock prices reflect the wisdom of decisions, short term and long term, instantaneously.

- The objective of stock price performance provides some very elegant theory on:
  - how to pick projects
  - how to finance them
  - how much to pay in dividends

Make sure firm objective is met: Corporate Governance (How?)

Corporate Governance



Corporate Governance (CG)

- What do we mean by the term *corporate governance*?

“Corporate governance is the system by which companies are directed and controlled.” Cadbury Report 1992

- What is its *purpose*?

“to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company.” UK Corporate Governance Code 2010

- The shareholders employ professional managers (known as directors) to manage the business for them. These directors may, therefore, be viewed as *agents* of the shareholders (who are the *principals*).

- It is about what the Board of a company does and how it sets the values of the company – not about day-to-day operational management

The Classical Objective Function

STOCKHOLDERS

Hire & fire managers
- Board
- Annual Meeting

Maximize stockholder wealth

Lend Money

BONDHOLDERS

Managers

No Social Costs

SOCIETY

Protect bondholder Interests

Costs can be traced to firm

Reveal information honestly and on time

Markets are efficient and assess effect on value

FINANCIAL MARKETS

What can go wrong? (Agency Problem)

- Corporate Governance structure and its effectiveness
- Annual Meetings (Not attended by shareholders)
- Board of Directors (Chairman and CEO)
- Lack of Expertise (Subject Specific)

What can go wrong? (Agency Problem)

- Bond Holder: Increase Dividend and Risky Projects
- Financial Market: Delay or Omission of Bad news (Even Fraudulent information)
- Social: Difficult to quantify, Voluntary nature and Obfuscation attempt, Cannot be traced to firms
- Personal Gain: Pay, bonuses and benefit

This is what can go wrong

STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

Lend Money

BONDHOLDERS

Managers

Significant Social Costs

SOCIETY

Bondholders can get ripped off

Some costs cannot be traced to firm

Delay bad news or provide misleading information

Markets make mistakes and can overreact

FINANCIAL MARKETS

The Counter Reaction

STOCKHOLDERS

1. More activist investors
2. Hostile takeovers

Managers of poorly run firms are put on notice.

Protect themselves

BONDHOLDERS ⟷ Managers ⟷ SOCIETY

Corporate Good Citizen Constraints

1. Covenants
2. New Types

1. More laws
2. Investor/Customer Backlash

Firms are punished for misleading markets

Investors and analysts become more skeptical

FINANCIAL MARKETS

Solutions: Corporate Governance and beyond

- Choose a <u>different objective</u> for the firm.

- Choose a <u>different mechanism</u> for corporate governance

Solution: Choose a Different Objective Function

- Firms can always focus on a different objective function. Examples would include:
  - maximizing earnings
  - maximizing revenues
  - maximizing firm size
  - maximizing market share

- The key thing to remember is that these are **intermediate** objective functions.
  - To the degree that they are correlated with the long-term health and value of the company, they work well.
  - To the degree that they do not, the firm can end up with a disaster

Solution: Corporate Governance Mechanism

- Hires and promotes qualified, honest people, and structures employees' financial incentives to motivate them to maximize firm value

- Corporate governance Mechanism:
  - Structure: e.g., Germany v/s Anglo-Saxon
  - Intuitional Investors and Stakeholders' Role
    - Institutional investors such as CALPERS and the Lens Funds have become much more active in monitoring companies that they invest in and demanding changes in the way in which business is done
    - At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors (**also long-term view**)
  - Specific Corporate Governance Mechanism (UNGC, Subject expert)

UK Corporate Governance Code: Focus on key Principles

*example from UK

UK Corporate Governance Code

- The **UK Corporate Governance Code** is essentially a consolidation and refinement of a number of different reports and codes concerning opinions on good corporate governance (targeting corporate scandals and financial fraud).

1st :

- CEO and Chairman of companies should be separated ensuring the absence of CEO duality.
- Boards should have at least three non-executive directors, two of whom should have no financial or personal ties to executives.
- Each board should have an audit committee composed of non-executive directors.

2nd :

- Each board should have a remuneration committee composed without executive directors, but possibly the chairman.
- Directors should have long term performance related pay, which should be disclosed in the company accounts and contracts renewable each year.

3rd :

- The Chairman of the board should be seen as the "leader" of the non-executive directors.
- Institutional investors should consider voting the shares they held at meetings, though rejected compulsory voting.
- All kinds of remuneration including pensions should be disclosed.

UK Corporate Governance Code

- Introduction of the **UK Corporate Governance Code**, which sets out best practice on corporate governance for large businesses listed on the London Stock Exchange.

- It is produced by the Financial Reporting Council, an independent regulator that seeks to promote high quality corporate governance and accountability.
  - Board Leadership
  - Division of responsibilities
  - Effectiveness of the board
  - Audit, risk and internal control
  - Remuneration

- In July 2018, the new 2018 UK Corporate Governance Code, which is designed to build on the relationships between companies, shareholders and stakeholders and make them key to long-term sustainable growth of the UK economy.

- Comply or explain: Provide principles and guidance rather than rigid rules.

UK Corporate Governance Code: Key Principles

- Leadership
- Effectiveness
- Accountability
- Remuneration
- Relations with shareholders

CG Key Principle: Leadership

- Every company should be headed by an ***effective board*** which is collectively responsible for the long-term success of the company.
- There should be a ***clear division of responsibilities*** at the head of the company........no one individual should have unfettered powers of decision.
- The ***chairman is responsible*** for leadership of the board and ensuring its effectiveness on all aspects of its role i.e., challenge CEO's performance.
- As part of their role as members of a unitary board, ***non-executive directors*** should constructively challenge and help to develop proposals on strategy.
- Separating role of ***CEO (executive) and Chairman (non-executive)***.
  (***<u>Pros and Cons</u>***)

Executive v/s Non- Executive Directors

Executive directors may feel that non-executive directors:

- **Are monitoring their behaviour**
- **Do not fully understand the company's business**
- **Do not devote enough time and effort**

Non-executives may feel that executive directors are:

- **Withholding key information or reports**
- **Failing to provide important information at the required time**
- **Holding informal meetings on important matters**

CG Key Principle: Effectiveness

- The board....should have the ***appropriate balance*** of skills, experience, independence and knowledge of the company .....

- There should be a formal, rigorous and transparent ***procedure for the appointment*** of new directors to the board

- All directors should be able to ***allocate sufficient time*** to the company to enable them to perform their duties effectively

- All directors should ***receive induction*** on joining the board and should regularly update and refresh their skills and knowledge

CG Key Principle: Accountability

- The board ***should present*** a balanced and understandable assessment of the company's position and prospects

- The board should maintain ***sound risk management and internal control systems.***

- The board should ***establish formal and transparent arrangements*** for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.

- ***For Example***: Audit Committee, Internal Audit and External Audit
  - i.e., adopting change in accounting policies, consistently applying accounting policies, educated judgement, track unusual trends/ items.

CG Key Principle: Remuneration

- Levels of remuneration ***should be sufficient to attract, retain and motivate directors*** of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose.

- A significant proportion of executive directors' remuneration should be structured so as to ***link rewards to corporate and individual performance (??)***.

- There should be a ***formal and transparent procedure for developing policy on executive remuneration*** and for fixing the remuneration packages of individual directors.

- ***No director should*** be involved in deciding his or her own remuneration

CG Key Principle: Relation with shareholders

- There should be a dialogue with shareholders ***based on the mutual understanding of objectives***.

- The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place

- The board should use the ***AGM to communicate*** with investors and to encourage their participation

Questions ?