

ACCT7106 – Session #5: Understanding the Financial Statements

PART 1 – Background

assumed objective of management = *maximize shareholders' wealth*

⇒ *maximize share price!*

roles / functions management executes in generating value –

1. **Controller function** ⇒ asset efficiency (efficient use of working capital)
2. **Treasury function** ⇒ long-term funds acquisition (debt or equity?)
3. **Capital budgeting** ⇒ real (productive) asset acquisition (fixed productive assets)

⇒ the fundamental decisions that ultimately determine the firm's profitability and its operating risk

⇒ the '**Value Drivers**'

Our objective – an understanding of how the firm (management) generates value

purpose – development of the pro-forma Financial Statements

⇒ **projected** over the forecast period $\left\{ \begin{array}{l} \text{Balance Sheet (B/S)} \\ \text{Income Statement (I/S)} \\ \text{Statement of Cash Flows (SCF)} \end{array} \right\}$

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➡ core inputs into the valuation model → x g

$$V_0 = \sum_{t=1}^{\infty} \frac{x_t}{(1+k_t)^t} = \sum_{t=1}^n \frac{E(x_t)}{(1+k)^t} + \frac{E(x_n)(1+g)}{k-g} \frac{1}{(1+k)^n}$$

Stages of the Analysis

Stage 1 – Understanding the Business

→ ‘Strategy Analysis’

- product market
- competition
- regulatory constraints
- business strategies
- technology



Stage 2 – Analysing Information

Accounting Analysis & Financial Analysis

- quality of accounting information
- reformulating the F/S to uncover business activities
- ratio and cash flow analysis

Stage 3 – Prospective Analysis: Forecasting

⇒ *pro-forma*

- Income Statement
- Balance Sheet
- Statement of Cash Flows



Stage 4 – Prospective Analysis: Valuation

- Abnormal Earnings Model
- Alternative Valuation Models
- Statement of Cash Flows



Stage 5 – Prospective Analysis: Application

→ investment decision

investor – decision to buy, hold, sell

manager – decision to adopt strategy or not

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e.g., *proforma Income Statement*

	2019	2020	2021E	2022E	2023E
Sales	38,176	37,408	± ? %	± ? %	± ? %
Other operating revenue	288	376			
Cost of sales	(29,253)	(28,043)	± ? %	± ? %	± ? %
Other income	428	108			
Administrative expenses	(8,031)	(8,081)	± ? %	± ? %	± ? %
Other expenses	(146)	---			
Share – equity investments	5	(6)			
Financing costs	(42)	(443)	± ? %	± ? %	± ? %
Income tax expense	(347)	(341)	± ? %	± ? %	± ? %

caution – for ‘clean surplus’ and consistent estimates, the accounting system must reconcile

⇒ must concurrently develop the proforma Balance Sheets and Statement of Cash Flows

⇒ **'tool box'** i.e.,

- ✓ external factors → economic climate (cycle), macroeconomic factors, political/regulatory, socio-cultural
- ✓ industry structure and dynamics → suppliers, buyers, new entrants, substitutes, rivalry
- ✓ competitive strategy → cost leader, differentiation, first mover

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Now seek to add an understanding of the firm's underlying **'financial performance'** to the 'tool box' by analysing the Financial Statements

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why? insights into (among other factors), operating policies, production technologies and techniques, inventory and credit systems

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operating decisions ↔ financial performance

Step #1 – the Financial Statements as presented ~ Session #5

Step #2 – reformulation of the Financial Statements

Step #3 – assessment of 'accounting quality' ~ Sessions #6, 7, 8

Step #4 – analysis ≡ ratios

➤ Reporting Obligations of Australian Publicly Listed Companies

Legally, publicly-listed Australian companies are public and 'disclosing entities' under the Corporations Act (2001)

⇒ they must provide:

- an annual financial report that includes financial statements, notes to the financial statements, and a directors' report
- the financial report must comply with Australian Accounting Standards (AASB standards) and must be audited
- the directors' report provides a summary across a broad range of aspects relating to the firm and its operations
- a half-year report that has similar requirements, but usually does not provide as much detail, and might be reviewed rather than audited

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- ❑ Listed companies must also comply with 'continuous disclosure' requirements
 - they must immediately disclose information that might materially affect their share price through the Australian Stock Exchange (ASX) website
(in the US, this is done through the Securities Exchange Commission (SEC) website instead)

- ❑ Information disclosed on the ASX website are called company 'announcements'
 - <https://www.asx.com.au/asx/statistics/announcements.do>
 - includes annual/half year reports
 - news released under continuous disclosure rules
 - insider trading reports
 - significant ownership reports

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➤ Accounting Standards (AASB)

- Australian companies must comply with Australian Accounting Standards Board pronouncements (AASB standards)
- these are a local variant of International Financial Reporting Standards (IFRS)
- IFRS standards are used in most countries, usually with minor local tweaks
- the US uses its own standards called US GAAP, that is not based on IFRS. However, IFRS and US GAAP are very similar

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→ the 'tools' developed in this course can be used broadly in any jurisdiction

➤ Financial Statements

❑ AASB 101 requires five things:

- Balance Sheet (or Statement of Financial Position)
- Income Statement (or Statement of Profit & Loss) *and/or* Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Cash Flows
- Notes to the financial statements

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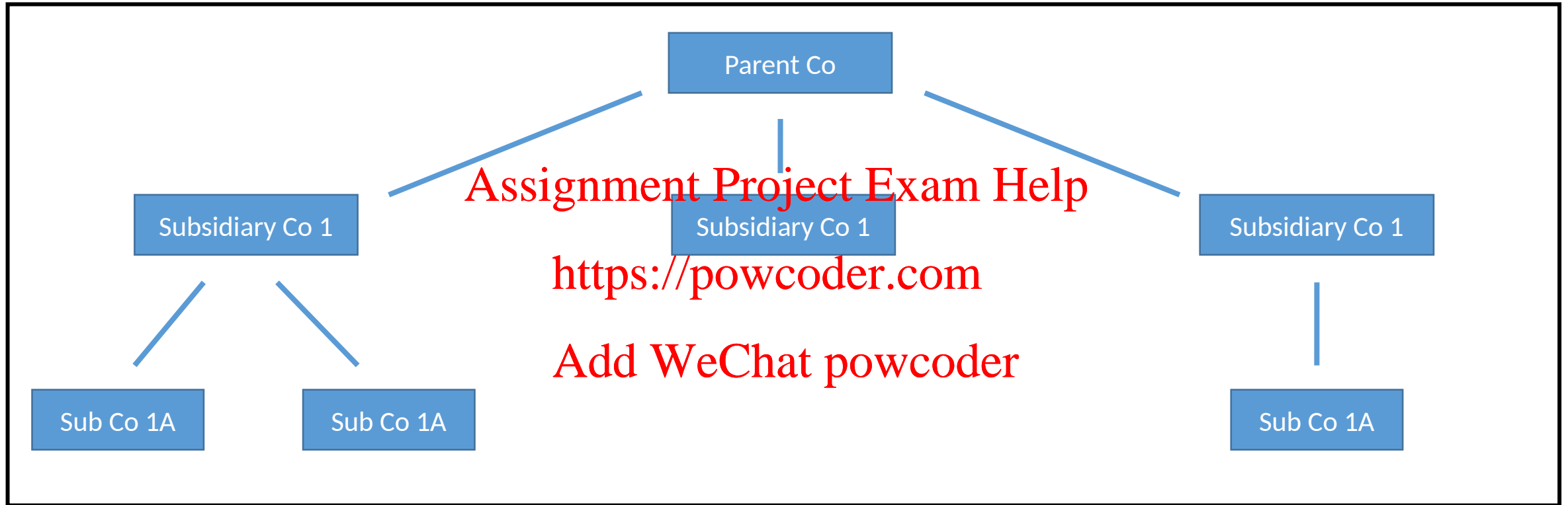
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❑ Comprehensive Income can be reported in two different ways:

- prepare a Statement of Comprehensive Income separate from the Income Statement, but immediately following it (*this is how Coles reports – pages 98/99*)
- combine the two as one Statement of Profit/Loss and Comprehensive Income

❑ Financial Statements must show at least two-years of comparative numbers under AASB 101 (e.g. FY19 and FY20 in the 2020 Annual Report)

- ❑ the financial statements we will be using are **Consolidated**, meaning they represent the combined financial statements of the parent company and all the subsidiaries it controls



the **consolidated entity** produces one set of Financial Statements

5.4 Subsidiaries

The ultimate parent of the Group is Coles Group Limited, a company incorporated in Australia. Subsidiaries are fully consolidated from the date of acquisition, being the date Coles Group Limited obtains control, and continue to be consolidated until the date control ceases. Control exists where the Group has the power to govern the financial and operating policies of the entity in order to obtain benefits from its activities.

Set out below are the subsidiaries of the Group. All entities were incorporated in Australia and wholly-owned unless stated otherwise.

Andearp Pty Ltd	Coles Retail Services Pty Ltd
Australian Liquor Group Ltd*	Coles Supermarkets Australia Pty Ltd*
Bi-Lo Pty. Limited*	Coles WFS Pty Ltd (formerly Wesfarmers Finance Pty Ltd)
Charlie Carter (Norwest) Pty Ltd	CSA Retail (Finance) Pty Ltd
Chef Fresh Pty Ltd	Coles Group Pty Ltd
CMPQ (CML) Pty Ltd	Eureka Operations Pty Ltd*
Coles Ansett Travel Pty Ltd (97.5%)	GBPL Pty Ltd
Coles Export Australia Pty Ltd	Grocery Holdings Pty Ltd*
(formerly Toorong Holdings Pty Ltd)	Katies Fashions (Aust) Pty Limited
Coles Financial Services Pty Ltd	Liquorland (Australia) Pty. Ltd*
Coles FS Holding Company Pty Ltd	
(formerly Wesfarmers Finance Holding Company Pty Ltd)	
Coles Group Deposit Services Pty Ltd	Now.com.au Pty Ltd
Coles Group Finance Limited*	Procurement Online Pty Ltd
Coles Group Properties Holdings Ltd*	Retail Ready Operations Australia Pty. Ltd*
Coles Group Property Developments Ltd*	Richmond Plaza Shopping Centre Pty Ltd
Coles Group Superannuation Fund Pty Ltd	Tickoth Pty Ltd
Coles Group Supply Chain Pty Ltd*	WFPL Funding Co Pty Ltd
Coles Group Treasury Pty Ltd	WFPL No 2 Pty Ltd
(formerly Coles Group Payments Pty Ltd)*	
Coles Online Pty Ltd*	WFPL Security SPV Pty Ltd
Coles Property Management Pty Ltd	WFPL SPV Pty Ltd
Entities formed/incorporated or acquired during the financial year	
Coles Export Asia Limited (incorporated in Hong Kong)	Coles Trading (Shanghai) Co. Limited (incorporated in China)
Entities deregistered during the financial year	
Tyremaster Pty Ltd	Now.com.au Pty Ltd
Waratah Cove Pty Ltd	Coles Group Finance (USA) Pty Ltd

* These entities are parties to the Deed of Cross Guarantee and members of the Closed Group as at 28 June 2020

Cautions –

- ❖ the financial statements are **general purpose**; they are prepared for a variety of stakeholders (shareholders, creditors, suppliers, customers, etc.)
- ❖ they are not set-out perfectly for shareholders and for doing valuation

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- ➡ need to 'reformulate' the financial statements in order to make them more useful for fundamental analysis and valuation
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- ⇒ separation of 'operating activities' and 'financing activities'

➤ Directors' Report

- ❑ Australian companies must provide a Directors' Report in their Annual Report
 - usually placed towards the start of the Annual Report
 - similar the 'Management Discussion & Analysis' (MD&A) provided by US firms
- ❑ the requirements for the Directors' Report are contain in the Corporations Act (2001, sections 299-300A) and Regulatory Guidance notes issued by ASIC (especially RG 247)
- ❑ the Directors' Report provides information useful for understanding how the company has performed, and some clues about how it might perform in the future e.g.,
 - description of the company's operations and strategy
 - explanation of the current year's results
 - business strategies
 - risks
 - future outlook

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Our vision, purpose and strategy

Our vision
Become the most trusted retailer in Australia and grow long-term shareholder value.

Our purpose
Sustainably feed all Australians to help them lead healthier, happier lives.

Smarter Selling
through efficiency and pace of change.

Win Together
with our team members, suppliers and communities.

Inspire Customers
through best value food and drink solutions to make lives easier.



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How we create value



Australian farmers and producers

Coles Supermarkets has an Australian-grown policy to provide our customers with quality Australian-grown fresh produce. By doing this, we are supporting Australian farmers and growers who provide us with healthy, quality products. Our support includes the \$60 million Coles Nurture Fund.

Suppliers, processors and packaging

Thousands of suppliers provide us with Own Brand and proprietary branded products. We are working with Own Brand suppliers to improve Own Brand packaging recyclability. Including labelling on Own Brand products to help customers recycle. REDcycle soft plastics recycling is available in our supermarkets.

Transport and distribution

Working with our logistics partners, we are reducing our environmental footprint through more efficient fleet movements. We are also ensuring customers are provided with quality, safe products by conducting selected quality checks when produce arrives at our fresh produce distribution centres, with additional checks for chilled products.

Our economic value creation

Suppliers	Team members	Shareholders	Governments	Community
\$29.9bn	\$4.8bn	\$873m	\$2.6bn	\$139m
supplier and services spend	payments and benefits to team members	total dividends paid	cash taxes paid and collected	community support

PART 2 – The Accounting Process:

(1) *Balance Sheet (B/S)*: position at a specific point in time measured in accordance with GAAP

(2) *Income Statement (I/S)*: summary of activities for period, part of bridge between two B/S

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(3) *Statement of Cash Flows (SCF)*: uses and sources of cash

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(4) *Notes to F/S*: supplementary information for full disclosure
The "building blocks" of Financial Accounting (GAAP) are:

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1) *basic elements* - definitions specific to accounting

2) *qualitative characteristics* - characteristics necessary for the F/S to meet users' needs

3) *environmental assumptions* - structure of framework within which accounting must function

4) *accounting principles* - broad standards/guidelines (man-made based on "logic" not on natural law)

➤ **Basic Elements** → definitions specific to accounting

e.g., *asset* - future benefit

- controlled by the firm
- result of a past transaction

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liability - currently exists, from a past transaction

- determinable maturity value and date
- payee identifiable
- cannot avoid future sacrifice (no offset)

'assets', 'liabilities', 'owners' equity', 'revenue', 'gain', 'expense', 'loss', 'earnings (net income)'

➤ **Qualitative Characteristics** → characteristics necessary for the F/S to meet users' needs

1. relevance - makes a difference in decisions i.e., improves predictive ability, confirms expectations
2. reliability - dependability
3. timeliness - information available before it loses capacity to influence decisions
4. verifiability
5. neutrality
6. comparability - improves both reliability and relevance
7. consistency - select the same method each year
8. uniformity - same method used by all firms

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➤ **Environmental Assumptions**

→ provide structure of framework within which accounting functions

1. *economic (separate) entity assumption* - each enterprise is considered as an accounting unit separate and apart from the owners and other entities irrespective of legal status

e.g., proprietorship: unlimited liability But keep books of "store" separately!

2. *periodicity assumption* - recognizes the need for short-term, periodic F/S even though the results can not be known specifically until liquidation

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3. *continuity assumption* - in absence of evidence to the contrary, the business entity is assumed to remain in operation long enough to carry out its contemplated operations, contracts, and commitments

4. *monetary unit assumption* - money is the best common denominator since it is "relevant, simple, available, understood, and useful" (also states that fluctuations in the value of the dollar can be ignored without impairing usefulness)

➤ *Accounting Principles*

- rules giving guidance to measurement, classification, and interpretation of economic information
- broad standards or guidelines (are man-made based on "logic" not on natural law)

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The next set of slides (#18 - #24) presents an illustration of the mechanics of accounting for a small retail organisation, and thereby the development of its Financial Statements

***** this material is illustrative only; it is not eligible for examination**

Example #5-1

In late 20X0, CM and MC decided to open a sporting goods wholesale operation, CMMC Ltd. The firm's balance sheet as at 31 December 31, 20X0 consisted of only two items, cash of \$1,000,000 and contributed capital of \$1,000,000. Information concerning the firm and its activities during 20X1 follows:

1. On January 1, 20X1, CMMC purchased land and a building for \$500,000, paying \$300,000 in cash and financing the remainder with a new \$200,000 10-year 12% bond issue. The fair market value of the land at that date was \$300,000. The building had an estimated life of 20 years and has no expected scrap value.

2. Because of its relative immaturity, CMMC decided to focus its attention on the distribution of only one item, sailboards. The following purchases were made in 20X1:

2 January: 350 units @ \$200 each

30 June: 400 units @ \$300 each

CMMC still owed suppliers \$55,000 at the end of the year.

3. Sales for the year were \$350,000 (700 units). While all sales were on credit, only \$85,000 remained uncollected at year-end. CMMC decided to use the FIFO method of inventory valuation. Based on the experiences of similar firms, CMMC believes that 1.5% of the outstanding receivables will ultimately be uncollectible.
4. CMMC paid \$4,000 for a two-year insurance policy on July 1, 20X1.
5. Administrative, selling, and general expenses (other than interest, depreciation, and labour) were \$31,000 for the year. All of these expenses had been paid by the end of the year.
6. Labour wages for 20X1 were to \$45,000. Of this amount, only wages from the last half of December remain unpaid (assume wages are earned uniformly throughout the year).
7. CMMC declared a dividend of \$30,000 on December 31, 20X1, to be paid on January 10, 20X2.
8. The firm's tax rate is 43%

'Mechanics' –

Step #1: Journal Entries

→ identifies each event and amount in the journals

Step #2: t-accounts

→ summarises each event and amount by account, and produces final balances

Step #3: Financial Statements

→ structured presentation of the final balances from the t-accounts

Journal Entries:

1.	DR land	300,000	DR int exp	24,000
	DR building	200,000	CR cash	24,000
	CR cash	300,000		
	CR B/P	200,000	DR amort exp	10,000
			CR acc amort	10,000
2.	DR inventory	70,000	DR inventory	120,000
	CR A/P	70,000	CR A/P	120,000
	DR A/P	135,000		
	CR cash	135,000		
3.	DR A/R	350,000	DR COGS	175,000
	CR sales	350,000	CR inventory	175,000
	DR cash	165,000	DR bad debt exp	1,275
	CR A/R	165,000	CR allowance	1,275
4.	DR pre-paid ins	4,000	DR ins exp	1,000
	CR cash	4,000	CR pre-pd ins	1,000
5.	DR s&ad exp	31,000	6. DR labour exp	45,000
	CR cash	31,000	CR cash	43,125
			CR wages payable	1,875
7.	DR R/E	30,000	8. DR tax exp	26,972
	CR div payable	30,000	CR cash	26,972

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t-accounts:

Permanent (balance sheet) accounts:

Cash		Accounts Receivable		Allowance		Inventory		Prepaid Insurance		Land	
1,000,000	300,000	350,000	265,000		1,275	70,000	175,000	4,000	1,000	300,000	
265,000	135,000					120,000		3,000		300,000	
	4,000	85,000			1,275						
	31,000										
	43,125					15,000					
	24,000										
	26,972										
700,903											
								Building		Accumulated Depreciation	
								200,000			10,000
								200,000			10,000

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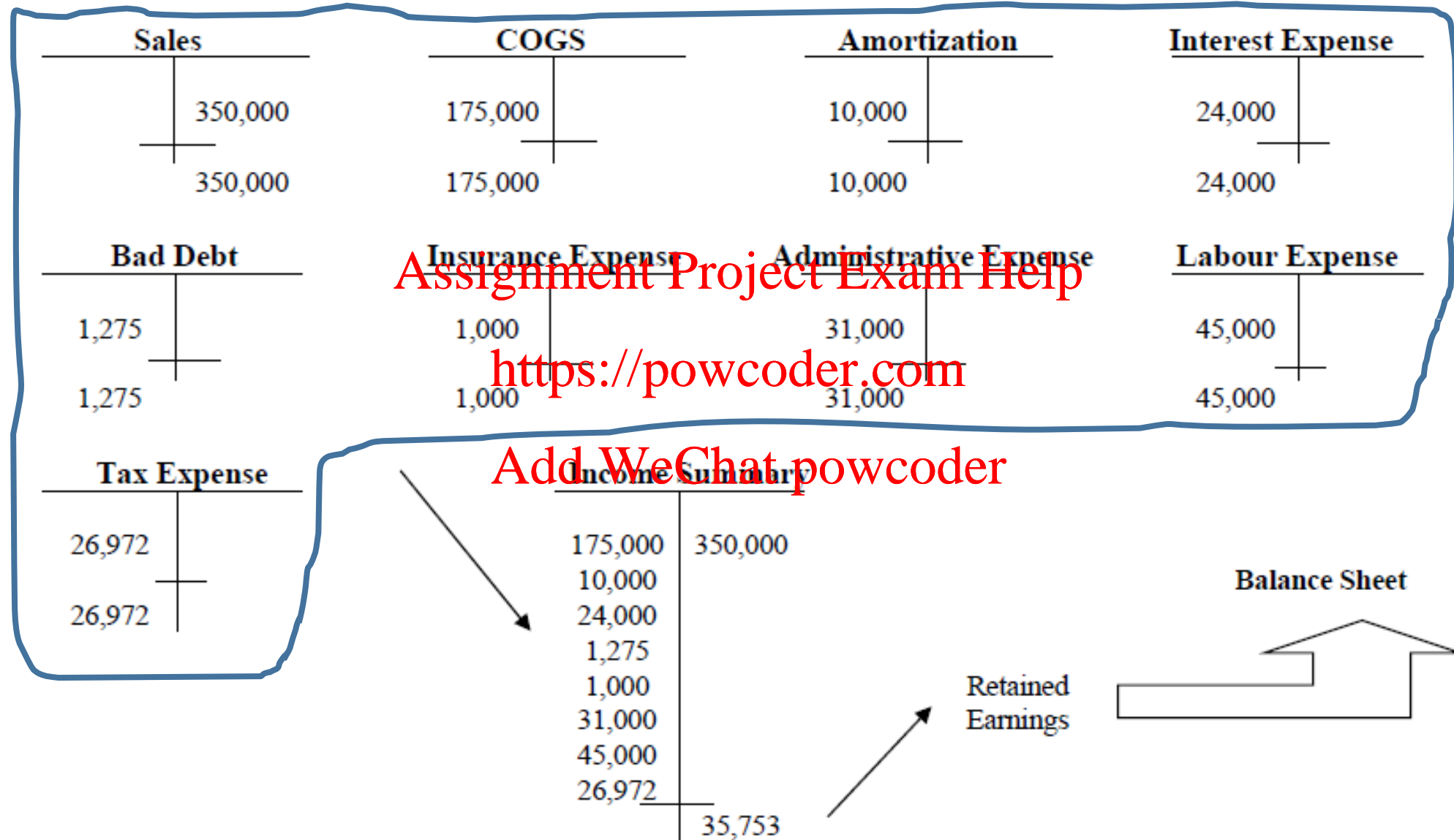
Accounts Payable		Wages Payable		Dividends Payable		Bonds Payable	
135,000	70,000		1,875		30,000		200,000
	120,000						
			1,875		30,000		200,000
	55,000						

Liabilities

Common Shares		Retained Earnings	
	1,000,000	30,000	35,753
	1,000,000		
			5,753

Shareholders' equity

Temporary (income statement) accounts:



CMMC Ltd.
Income Statement for the year ended December 31, 20X1

Sales		
350,000		
COGS		
<u>(175,000)</u>		
Gross Profit		
175,000		
Operating Expenses		
depreciation	10,000	
bad debt expense	1,275	
insurance	1,000	
administrative	31,000	
labour expense	<u>45,000</u>	
<u>(88,275)</u>		
Operating Income		86,725
Financing costs (interest expense)		<u>(24,000)</u>
NIBT		62,725

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CMMC Ltd.
Balance Sheet, December 31, 20X1

cash		
700,903		
accounts receivable	85,000	
allowance	<u>(1,275)</u>	
83,725		
inventory		
15,000		
prepaid insurance		
3,000		
land		300,000
building	200,000	
acc dep ⁿ	<u>(10,000)</u>	
<u>190,000</u>		-
Total Assets		
<u>1,292,628</u>		
accounts payable		55,000
wages payable		

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CMMC Ltd.

Statement of Cash Flows for the year ended December 31, 20X5

Operations:

Cash receipts	265,000	
purchases	(135,000)	
insurance	(4,000)	
G,S & A expenses	(31,000)	
labour	(43,125)	
interest	(24,000)	
taxes	<u>(26,972)</u>	903

Investing:

purchase of land	(300,000)	
purchase of building	(200,000)	(500,000)

Financing:

bonds payable	200,000	
dividends	<u>(0)</u>	<u>200,000</u>

Net Decrease in Cash (299,097)

PART 3 – The Financial Statements

1. Balance Sheet (Statement of Financial Position:

- presents the company's financial position as at a particular point in time (end of the reporting period)
- classifications: Assets, Liabilities and Equity
- Assets and Liabilities further classified into:
 - current (realised within 12 months)
 - non-current (economic value to firm > 12 months)
- Accounting relation: $\text{Total Assets} = \text{Total Liabilities} + \text{Common Shareholders' Equity}$

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Companies must show *at least* the following items on the *face* of the Balance Sheet (assuming the item exists for the company) (AASB 101):

- Assets:
 - Property, plant and equipment (PPE)
 - Investment property
 - Intangible assets
 - Financial assets
 - Investment accounted for using the equity method
 - Inventories
 - Trade and other receivables
 - Cash & cash equivalents
 - Assets held for sale as part of discontinued operations
 - Deferred tax assets
- Liabilities:
 - Trades and other payables
 - Provisions
 - Financial liabilities
 - Income tax payable
 - Deferred tax liabilities
 - Liabilities associated with discontinued operations
- Equity:
 - Non-controlling interests (NCI)
 - Issued capital
 - Reserves

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Total Assets = Total Liabilities + Shareholders' Equity

	NOTES	CONSOLIDATED	
		28 JUNE 2020 \$M	30 JUNE 2019 \$M
Assets			
Current assets			
Cash and cash equivalents	2.1	992	940
Trade and other receivables	2.2	434	360
Inventories	2.4	2,166	1,965
Income tax receivable		42	-
Assets held for sale	5.2	75	94
Other assets	2.3	70	47
Total current assets		3,779	3,406
Non-current assets			
Property, plant and equipment	2.5	4,127	4,119
Right-of-use assets	2.7	7,660	-
Intangible assets	2.6	1,597	1,541
Deferred tax assets	1.6	849	365
Equity accounted investments	5.1	217	212
Other assets	2.3	120	134
Total non-current assets		14,570	6,371
Total assets		18,349	9,777

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Liabilities**Current liabilities**

Trade and other payables	2.8	3,737	3,380
Provisions	2.9	861	743
Lease liabilities	2.7	885	-
Other		198	168
Total current liabilities		5,681	4,291

Non-current liabilities

Interest-bearing liabilities	3.1	1,354	1,460
Provisions	2.9	472	598
Lease liabilities	2.7	8,198	-
Other		29	71
Total non-current liabilities		10,053	2,129

Total liabilities**Net assets****Equity**

Contributed equity	3.2	1,611	1,628
Reserves		43	42
Retained earnings		961	1,687
Total equity		2,615	3,357

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2. Income Statement ('Statement of Financial Performance' or 'Profit and Loss Statement')

- shows financial performance over a period of time (usually 12 months)
- the core aspect of the I/S typically has the following basic structure:

Revenue

- Cost of goods sold (COGS)

= Gross margin (or gross profit)

- Operating expenses (SG&A, wages, advertising, R&D)

= Earnings before interest, tax, depreciation and amortisation (EBITDA)

- Depreciation and amortisation

= Earnings before interest and tax (EBIT)

- Net interest expense (or net of interest revenue)

= Profit before tax (PBT)

- Income tax expense

= Net profit after tax (NPAT) (but before extraordinary items)

- ± extraordinary items

= Net Income

- Preferred dividends

= Net Income to Common Shareholders

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	NOTES	CONSOLIDATED	
		YEAR ENDED	YEAR ENDED
		28 JUNE 2020	30 JUNE 2019
		\$M	\$M
Continuing operations			
Sales revenue	1.3	37,408	38,176
Other operating revenue		376	288
Total operating revenue		37,784	38,464
Cost of sales		(28,043)	(29,253)
Gross profit		9,741	9,211
Other income		108	428
Administration expenses	1.4	(8,081)	(8,031)
Other expenses		-	(146)
Share of net (loss) / profit of equity accounted investments	5.1	(6)	5
Earnings before interest and tax (EBIT)		1,762	1,467
Financing costs	1.5	(443)	(42)
Profit before income tax		1,319	1,425
Income tax expense	1.6	(341)	(347)
Profit for the year from continuing operations		978	1,078
Discontinued operations			
Profit from discontinued operations after tax	5.3	-	357
Profit for the year		978	1,435
Profit attributable to:			
Equity holders of the parent entity		978	1,435
Earnings per share (EPS) attributable to equity holders of the parent:			
Basic and diluted EPS (cents)		73.3	107.6
EPS attributable to equity holders of the parent from continuing operations:			
Basic and diluted EPS (cents)	1.2	73.3	80.8

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3. Statement of Changes in Shareholders' Equity

- provides a detailed break-down of changes in equity accounts over the period
- Shareholders' Equity typically consists of up to five accounts:
 - **Contributed capital:** how much shareholders have historically invested in the company
 - **Treasury stock:** cost of shares repurchased (but not retired)
 - **Retained earnings:** (basically) sum of past profits less past dividends
 - **Non-controlling interest (minority interest):** portion of controlled subsidiaries not owned by the parent company
 - **Reserves:** used for various items that affect equity, but do not pass into retained earnings (typically these items go through Other Comprehensive Income) e.g.,
 - if PPE is revalued upwards to fair value, the increment is placed in a Revaluation Reserve (AASB 116)
 - most companies place share-based payments in a reserve until the share-based payments (typically options) are exercised/expire (AASB 2)
 - translation of foreign operations into the company's presentation currency (AASB 121)

changes in equity accounts can be classified into two categories:

Comprehensive income (CI):

=NPAT

+OCI

Net transactions with shareholders:

= Cash dividends

+ Share repurchases (treasury share repurchased, etc.)

- Shares issued (dividend reinvestment plans, issued to executives or NCI, treasury shares issued, etc.)

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Statement of Changes in Equity
for the year ended 28 June 2020

	ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT				
	CONTRIBUTED EQUITY	SHARE-BASED PAYMENTS RESERVE	CASH FLOW HEDGE RESERVE	RETAINED EARNINGS	TOTAL
	\$M	\$M	\$M	\$M	\$M
At 1 July 2019	1,628	43	(1)	1,687	3,357
Effect of adoption of IFRS 9 (Losses)	-	-	-	(831)	(831)
At 1 July 2019 (adjusted)	1,628	43	(1)	856	2,526
Net profit for the year	-	-	-	978	978
Other comprehensive income	-	-	(12)	-	(12)
Total comprehensive income for the year	-	-	(12)	978	966
Share-based payments expense	-	13	-	-	13
Purchase of shares under Equity Incentive Plan	(17)	-	-	-	(17)
Dividends paid	-	-	-	(873)	(873)
Balance as at 28 June 2020	1,611	56	(13)	961	2,615
At 1 July 2018	2,193	39	-	1,018	3,250
Net profit for the year	-	-	-	1,435	1,435
Other comprehensive income	-	-	(1)	-	(1)
Total comprehensive income for the year	-	-	(1)	1,435	1,434
Capital return	(538)	-	-	-	(538)
Share-based payments expense	-	4	-	-	4
Purchase of shares under Equity Incentive Plan	(27)	-	-	-	(27)
Distributions to Wesfarmers	-	-	-	(766)	(766)
Balance as at 30 June 2019	1,628	43	(1)	1,687	3,357

The accompanying notes form part of the consolidated financial statements.

4. Statement of Cash Flows

- sources and uses of cash over a period of time (usually 12 months)
- similar to the Income Statement, but based on cash accounting, rather than accrual accounting
- structure:
 - cash flow from operations (CFO):
 - cash flow from investing (CFI):
 - cash flow from financing (CFF):
- CFO can be presented in two different ways in Australia:
 - *Direct method*: itemised cash receipts less cash payments related to operations
 - *Indirect method*: profit +/- non-cash items and net changes in working capital
- the direct method was historically required in Australia and is still the most common
- the indirect method can be used in Australia and is very common in other countries
- in Australia, if the direct method is used, the indirect method must be shown in the notes

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	NOTES	CONSOLIDATED	
		YEAR ENDED	YEAR ENDED
		28 JUNE 2020	30 JUNE 2019
		\$M	\$M
Cash flows from operating activities			
Receipts from customers		39,971	41,126
Receipt from Viva Energy		-	137
Payments to suppliers and employees		(36,486)	(38,665)
Interest paid		(37)	(33)
Interest component of lease payments		(399)	-
Interest received		7	4
Income tax paid		(504)	(294)
Net cash flows from operating activities	2.1	2,552	2,275
Cash flows used in investing activities			
Purchase of property, plant and equipment and intangibles		(833)	(1,104)
Proceeds from sale of property, plant and equipment		211	288
Proceeds from sale of controlled entities		-	544
Net investments in joint venture and associate	5.1	(11)	(6)
Acquisition of subsidiaries or businesses, net of cash acquired		(25)	(2)
Net cash flows used in investing activities		(658)	(280)
Cash flows used in financing activities			
Proceeds from borrowings		5,120	10,260
Repayment of borrowings		(5,226)	(8,800)
Proceeds from borrowings with related parties		-	170
Repayment of borrowings with related parties		-	(3,678)
Payment of principal component of lease payments		(846)	-
Distributions to Wesfarmers		-	(320)
Redemption of redeemable preference shares		-	1,322
Dividends paid		(873)	-
Capital return		-	(538)
Purchase of shares under Equity Incentive Plan		(17)	(27)
Net cash flows used in financing activities		(1,842)	(1,611)

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indirect method
from Footnote 2.1

Reconciliation of profit for the period to net cash flows from operating activities

	CONSOLIDATED	
	YEAR ENDED	YEAR ENDED
	28 JUNE 2020	30 JUNE 2019
	\$M	\$M
Profit for the period	978	1,078
<i>Adjustments for:</i>		
Depreciation and amortisation	1,495	640
(Impairment reversals) / impairment and write-off of non-current assets	(41)	42
Net gain on sale of controlled entities	-	(133)
Net loss on disposal of non-current assets	39	5
Share of loss / (profit) of equity accounted investments	6	(5)
Share-based payments expense	13	4
Other	-	(4)
<i>Changes in assets and liabilities net of the effects of acquisitions and disposals of businesses and impact of IASB M:</i>		
(Increase) / decrease in inventories	(201)	137
Increase in trade and other receivables	(78)	(45)
Increase in prepayments	(20)	(1)
Increase in other assets	(4)	(11)
Increase in deferred tax assets	(121)	(91)
(Increase) / decrease in income tax receivable	(42)	143
Increase / (decrease) in trade and other payables	339	(9)
Increase in provisions	138	586
Increase / (decrease) in other liabilities	51	(61)
Net cash flows from operating activities	2,552	2,275

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5. Notes to the Financial Statements (pages 103 – 148 of Coles 2020 Annual Report)

- usually appear at the end of the financial report after the financial statements
- typically provide details of the following:
 - description of accounting policies
 - details of segments
 - finer detail on financial statement items
 - miscellaneous disclosures required under Australian law, such as list of subsidiaries, shareholder statistics, major shareholders

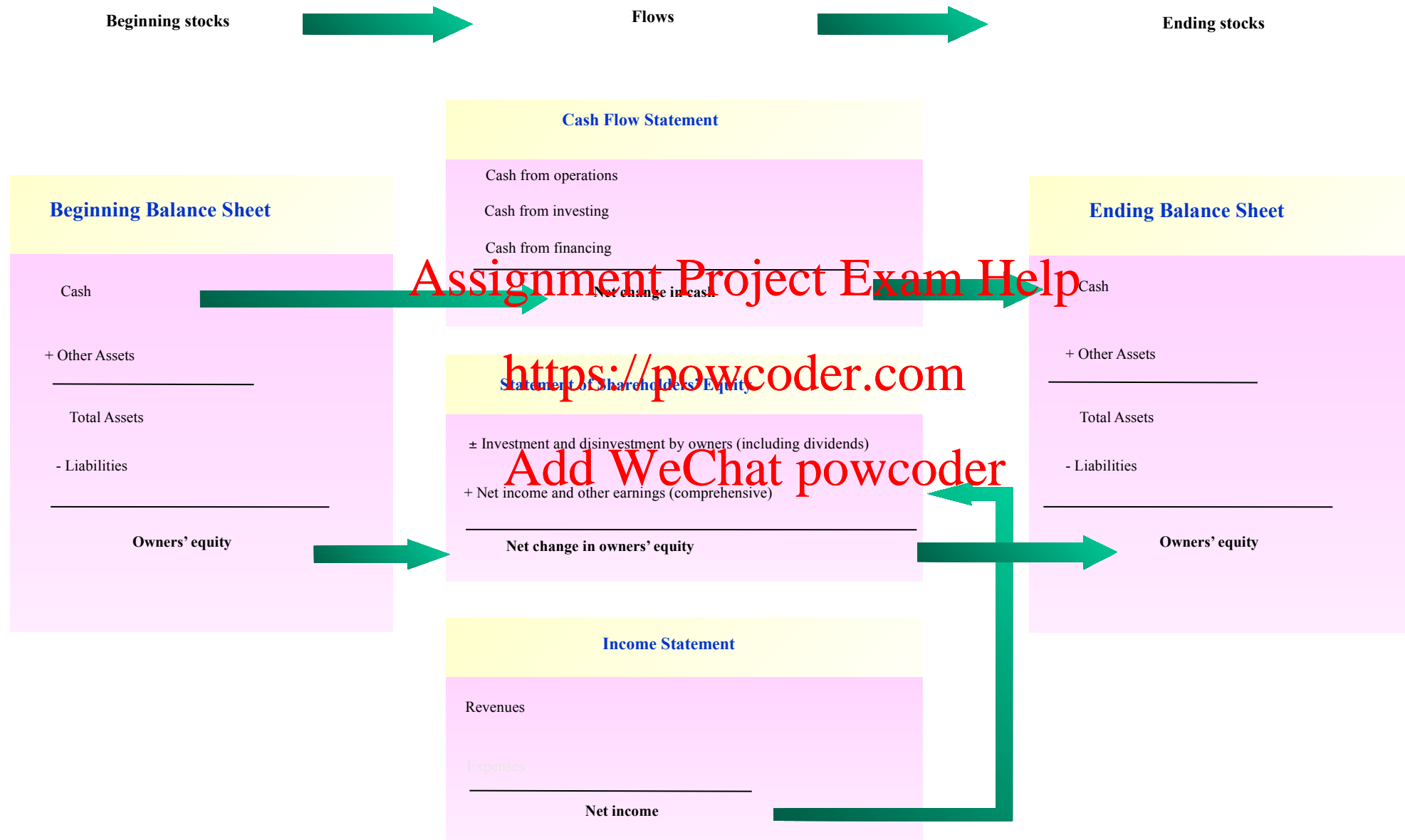
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The details provided in the 'Notes' are an imperative for fully understanding the information conveyed by the Financial Statements (I/S, B/S, and SCF)

The Articulation of the Financial Statements (Figure 2.1, page 42)



PART 4 – Comprehensive income (CI) (and ‘dirty’ versus ‘clean’ surplus)

The ‘*clean surplus*’ relation is the standard accounting identity

Ending book value (shareholders’ equity)

= beginning book value + income – dividends ± changes in contributed capital

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$$BV_t = BV_{t-1} + E_t - D_t \pm NCC_t$$

The key within this equation is that income (E) is in fact ‘comprehensive income’ (CI) and not ‘net profit after tax’ (NPAT or OI)

consider Coles again

	NOTES	CONSOLIDATED	
		YEAR ENDED 28 JUNE 2020	YEAR ENDED 30 JUNE 2019
		\$M	\$M
Continuing operations			
Sales revenue	1.3	37,408	38,176
Other operating revenue		376	288
Total operating revenue		37,784	38,464
Cost of sales		(28,043)	(29,253)
Gross profit		9,741	9,211
Other income		108	428
Administration expenses	1.4	(8,081)	(8,031)
Other expenses		-	(146)
Share of net (loss) / profit of equity accounted investments	5.1	(6)	5
Earnings before interest and tax (EBIT)		1,762	1,467
Financing costs	1.5	(443)	(42)
Profit before income tax		1,319	1,425
Income tax expense	1.6	(341)	(347)
Profit for the year from continuing operations		978	1,078
Discontinued operations			
Profit from discontinued operations after tax	5.3	-	357
Profit for the year		978	1,435
Profit attributable to:			
Equity holders of the parent entity		978	1,435

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Statement of Other Comprehensive Income

for the year ended 28 June 2020

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	NOTES	CONSOLIDATED	
		YEAR ENDED 28 JUNE 2020 \$M	YEAR ENDED 30 JUNE 2019 \$M
Profit for the year		978	1,435
Other comprehensive income			
Items that may be reclassified to profit or loss:			
Net movement in the fair value of cash flow hedges		(17)	(2)
Income tax effect	1.6	5	1
Other comprehensive loss which may be reclassified to profit or loss in subsequent periods		(12)	(1)
Total comprehensive income attributable to:			
Equity holders of the parent entity		966	1,434
Total comprehensive income from continuing operations attributable to:			
Equity holders of the parent entity		966	1,077

The accompanying notes form part of the consolidated financial statements.

Statement of Changes in Equity

	ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT				
	CONTRIBUTED	SHARE-BASED	CASH FLOW	RETAINED	TOTAL
	EQUITY	PAYMENTS	HEDGE	EARNINGS	
	\$M	RESERVE	RESERVE	\$M	
At 1 July 2019	1,428	45	(1)	1,467	3,357
Effect of adoption of AASB 16 Leases	-	-	-	(831)	(831)
At 1 July 2019 (adjusted)	1,628	45	(1)	856	2,526
Net profit for the year	-	-	-	978	978
Other comprehensive income	-	-	(12)	-	(12)
Total comprehensive income for the year	-	-	(12)	978	966
Share-based payments expense	-	13	-	-	13
Purchase of shares under Equity Incentive Plan	(17)	-	-	-	(17)
Dividends paid	-	-	-	(873)	(873)
Balance as at 28 June 2020	1,611	56	(13)	961	2,615

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Accounting adjustment

BV_{t-1}

Comprehensive Income

NCC

Dividends

BV_t 44

Comprehensive Income (CI)

- basically a more complete measure of performance than 'net profit after tax' (NPAT)
- $CI = NPAT + \text{Other Comprehensive Income (OCI)}$
- OCI is also called 'dirty surplus' – it is termed 'dirty' because it is not counted towards NPAT (note – surplus is an 'old' name for profit)
- CI satisfies an important relation called the clean surplus relation (CSR):
(usually, net profit does not satisfy this relation)
- a list of OCI items appears in AASB 101 (and is summarised following):
bottom line – basically a lot of messy, complicated things; the most common ones are FX translation gains/losses and cash flow hedging gains/losses

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- (a) changes in revaluation surplus (AASB 116 Property, Plant and Equipment and AASB 138 Intangible Assets);
- (b) re-measurements of defined benefit plans (AASB 119 Employee Benefits);
- (c) gains and losses arising from translating the financial statements of a foreign operation (AASB 121 The Effects of Changes in Foreign Exchange Rates);
- (d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of AASB 9 Financial Instruments;
- (da) gains and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of AASB 9.
- (e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of AASB 9 (Chapter 6 of AASB 9);
- (f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (paragraph 5.7.7 of AASB 9);
- (g) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value (Chapter 6 of AASB 9); and
- (h) changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (see Chapter 6 of AASB 9).

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PART 5 – Accounting Concepts: Recognition and Disclosure

- ❑ **Recognition** → formally including an item in the financial statements
- ❑ **Disclosure** → merely disclosing the existence of an item in the Notes, but not formally including it in the financial statements

Example: contingent liabilities **Assignment Project Exam Help**

“A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity” (AASB 137)

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e.g., a loan guarantee – will only become a liability only if the other company defaults (or becomes likely to default)

- does NOT currently meet the definition of a liability and hence can not be formally recognised (included) in the Balance Sheet (*see Slide #16 for definition of a liability*)
- disclosed in the notes (*see Coles 2020 Annual Report Note 6.2 on page 143*)

Accounting Policies

➤ Revenue Realization Principle:

- revenue is the creation of wealth
 - ➔ any inflow other than from owners' equity or creditors, measured as net cash equivalent price from an arm's length transaction
- in general, revenue is recognized when there has been an exchange transaction and the earnings process is essentially complete
 - ➔ sales basis (employed when collection of price in full is reasonably certain and when related expenses are determinable)

➤ Matching Principle:

- based on cause and effect i.e., all expenses incurred in generating revenue should be reported in the period when the revenue is recognized

definitions:

expenditure - decrease in asset or increase in liability associated with incurrence of a cost

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expense – using up of resources by entity's earnings activities during current period

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⇒ an expenditure may benefit the period in which it occurs and/or future periods (e.g., acquisition of fixed assets) whereas an expense is of benefit only to the period in which it is consumed

⇒ an item of cost must either be defined as an asset or as an expense

e.g., purchase inventory for resale - becomes cost of goods sold (COGS) on I/S only in period when sold else held on the B/S as an asset (inventory)

exceptions to the matching principle include

a) period expenses

- costs of doing business e.g., administrative costs, costs of accountant, etc.
- these costs are expensed in the period in which they are incurred

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future period

why? they don't have an obvious link to revenue of some

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question - what about advertising expenses? will impact on future revenue BUT

causal link is difficult to establish

⇒ are typically expensed in period when incurred

b) dividends

- dividends are not expenses from the accounting perspective

⇒ recorded directly to Retained Earnings (as a reduction) ***when declared***

Accounting Concepts: Accruals

Why accrual accounting?

- recognises revenues (expenses) when they are earned (incurred), rather than when the cash is received (paid)
- resulting earnings generally provides a better measure of economic value added than cash flow
e.g., suppose a company made \$10m in cash sales and \$100m in credit sales for a year – looking only at cash sales would provide an incomplete picture of the company's performance
- accruals accounting is better for forecasting – it produces smoother and more predictable earning
- accrual accounting simply changes the timing of when items are recognised in the F/S - over the life of the company, cash flows and revenues/expenses must be the same
- accruals involve some estimation (e.g., provision for doubtful debts) – this introduces the possibility of estimation errors

- the main measure of performance under accrual accounting is NPAT (or CI)
- the main measure under cash accounting is CFO
- total accruals = NPAT – CFO

From the Coles' presentation in Footnote 2.1 of its CFO using the indirect method

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Profit = 978

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Accruals = 1,574 (adding up all the adjustments and changes in assets and liabilities)

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CFO = 2,552

caution – determination of 'accruals' involves managerial discretion (e.g., estimates) and thereby can impact the quality of the accounting figures

Reconciliation of profit for the period to net cash flows from operating activities

	CONSOLIDATED	
	YEAR ENDED	YEAR ENDED
	28 JUNE 2020	30 JUNE 2019
	\$M	\$M
Profit for the period	978	1,078
<i>Adjustments for:</i>		
Depreciation and amortisation	1,495	640
(Impairment reversals) / impairment and write-off of non-current assets	(41)	42
Net gain on sale of controlled entities	-	(133)
Net loss on disposal of non-current assets	39	5
Share of loss / (profit) of equity accounted investments	6	(5)
Share-based payments expense	13	4
Other	-	(4)
<i>Changes in assets and liabilities net of the effects of acquisitions and disposal of businesses and impacts of AASB 16:</i>		
(Increase) / decrease in inventories	(201)	137
Increase in trade and other receivables	(78)	(45)
Increase in prepayments	(20)	(1)
Increase in other assets	(4)	(11)
Increase in deferred tax assets	(121)	(91)
(Increase) / decrease in income tax receivable	(42)	143
Increase / (decrease) in trade and other payables	339	(9)
Increase in provisions	138	586
Increase / (decrease) in other liabilities	51	(61)
Net cash flows from operating activities	2,552	2,275

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PART 6 – Accounting Concepts: Measurement

- having decided to recognise an item in the Financial Statements, its value (amount) must then be measured –
- four main measurements methods used under AASB/IFRS (see Conceptual Framework):
 - **Historical Cost:** how much the item originally cost less (if applicable) accumulated depreciation/amortisation and less (if applicable) accumulated impairments
 - **Fair Value** (or current cost): basically current market value – what would it cost today to buy the asset or to repay the liability
 - **Realisable Value:** what could the asset be sold for today?
 - **Present Value:** present value of future cash flows related to the asset or liability

(note – typically, Realisable Value and Present Value are viewed as being the same as Fair value)

Cash and Cash Equivalents	Fair value (cash is cash)
Accounts Receivable, net of Provision for Doubtful Debts	Expected amount to be collected from receivables. This should be close to Fair value
Inventories	Lower of cost and net realisable value
Property, plant and equipment (PPE)	Can be carried at Historical cost (most companies) or Fair value less depreciation and impairments
Intangibles	Can be carried at Historical cost (most companies) or Fair value less amortisation and impairments
Goodwill	Historical cost (with impairments, but no amortisation)
Investment property	Fair value (typically) or Historical cost

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Accounts payable	Historical cost, which is usually close to fair value
Borrowings	Amortised cost (usually); fair value is permitted, but not used often by industrial companies
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Deferred revenue	Estimated revenue to be earned in the future. This should be close to fair value
Provisions, e.g., provision for warranty expenses	Present value of estimated future expenses. This should be close to fair value

Measurement – Equity Investments

For equity investments in another company, the accounting depends on whether the company has 'control', 'significant influence', or neither

❖ **Control** (usually >50% ownership):

- the investee company is known as a 'subsidiary' and the owner is called the 'parent'
- consolidation method: basically add the subsidiary and parent's accounts together – no separate asset for the investment is recognised

❖ **Significant influence** (usually 20-50% ownership):

- the investee company is known as an 'associate'
- equity method of accounting: recognise an asset on balance sheet; recognise share of profits/losses of associate; recognise dividends received from associate

❖ **Joint control** (usually 50% ownership):

- the investee company is known as a 'joint venture'
- equity method of accounting is used

❖ **Neither** (usually < 20% ownership):

- recognise an asset
- measurement depends on management's intention

For investments in debt securities (e.g. bonds) and minor investments in equity securities (<20% ownership), measurement depends on management's intentions with respect to the investment

❖ **Held to maturity** (debt only)

- management intends to hold the debt until it matures
- measurement is at amortised cost

❖ **Held for trading** (debt/equity)

- management intends profit from trading the debt/equity
- measurement at fair value, with gains/losses recognised in the Income Statement

❖ **Available for sale** (debt/equity)

- management's intention is not to hold to maturity or hold for trading
- measurement at fair value, with gains/losses recognised in OCI

(note – see updated AASB 9 for specific details)

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Accounting Concepts: Classification

- once an item is recognised and measured, the final decision is how to classify the item
- typical issues:
 - is an item a liability or equity? (Balance Sheet)
 - is an item a recurring or non-recurring item (e.g. an extraordinary item)? (Income Statement)
 - is it an operating, investing or financing cash flow (e.g. interest paid)? (Cash Flow Statement)

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- our interest is also in re-classification

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example: preference shares – financial instruments that have features of both equity and liabilities

equity: pay dividends; rank below debt in payment of dividends and repayment on liquidation

liability: typically dividends are fixed; rank above ordinary shares for dividends and repayments

⇒ difficult to classify in the Balance Sheet: are they liabilities or equity?

in practice, can be classified as liabilities, equity or split into both (depending on the exact terms of the preference share)

we will reclassify all preference shares as financial obligations

Accounting Concepts: Going Concern Assumption

- IFRS/AASB accounting is done on the basis that the company will continue to operate for the foreseeable future (it is a **going concern**) (continuity assumption, Slide #18)
 - ⇒ the business/company/venture is an ongoing, continuing business
- AASB 101:
 - management must assess whether the company is a going concern i.e., it is not likely to be liquidated or cease to trade – management must disclose if there is uncertainty
 - if a going concern, normal accounting is used; if not, the company should disclose the accounting method (could be anything)
- auditors must check on management's going concern assessment (see ASA 570)
- for purposes of the valuation exercise, we typically assume the company is a going concern (there are special valuation techniques for companies that are not going concerns, for example asset-based valuation)

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PART 7 – Summary: Sessions #1 → #5

overarching focus – fundamental value (‘intrinsic value’)

- requires an understanding of the ‘value drivers’
- ➔ need to accumulate a ‘tool kit’ as the basis for developing the

perform a Financial Statements
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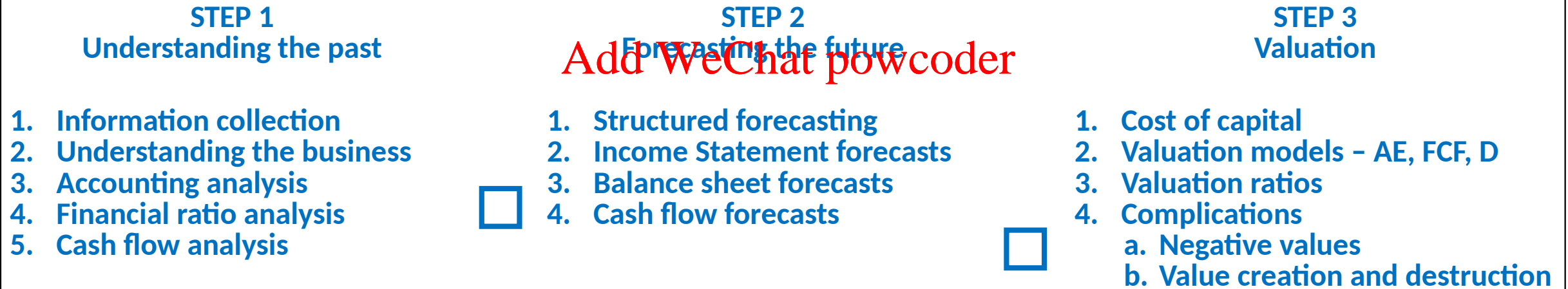


Figure 1.1 Lundholm & Sloan, *Framework for Equity Valuation*

Stages of the Analysis

Stage 1 – Understanding the Business

→ ‘Strategy Analysis’

- product market
- competition
- regulatory constraints
- business strategies
- technology



Stage 2 – Analysing Information

Accounting Analysis & Financial Analysis

- quality of accounting information
- reformulating the F/S to uncover business activities
- ratio and cash flow analysis

Stage 3 – Prospective Analysis: Forecasting

⇒ *pro-forma*

- Income Statement
- Balance Sheet
- Statement of Cash Flows



Stage 4 – Prospective Analysis: Valuation

- Abnormal Earnings Model
- Alternative Valuation Models
- Statement of Cash Flows



Stage 5 – Prospective Analysis: Application

→ Investment decision

investor – decision to buy, hold, sell

manager – decision to adopt strategy or not

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external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

Analysis of Financial Statements

- understanding current F/S
- re-formulating the F/S
- accounting quality

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Industry dynamics

→ Porter's five forces

(suppliers, buyers, new entrants, substitutes, rivalry)



??

e.g., proforma Income Statement

	2019	2020	2021E	2022E	2023E
Sales	38,176	37,408	± ? %	± ? %	± ? %
Other operating revenue	288	376			
Cost of sales	(29,253)	(28,043)	± ? %	± ? %	± ? %
Other income	428	108			
Administrative expenses	(8,031)	(8,081)	± ? %	± ? %	± ? %
Other expenses	(146)	---			
Share – equity investments	5	(6)			
Financing costs	(42)	(443)	± ? %	± ? %	± ? %
Income tax expense	(347)	(341)	± ? %	± ? %	± ? %

caution – for ‘clean surplus’ and consistent estimates, the accounting system must reconcile

⇒ must concurrently develop the proforma Balance Sheets and Statement of Cash Flows