Financial Statement Analysis

BY:
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Analysis of

Assets, Liabilities & Equity and Income and Expenses

Assets, Liabilities & Equity and Income and Expenses

Assets

- In simple meaning Asset means what the company owns
- Various types of Assets are mentioned below :
  - Non – Current Assets
  - Current Assets

Assets, Liabilities & Equity and Income and Expenses

Assets

- Current Assets :
  - Cash or expected to be turned in cash in the next year
    - Cash
    - Marketable Securities
    - Accounts Receivables
    - Inventories
    - Other Current Assets (Prepaid Expenses)

Assets, Liabilities & Equity and Income and Expenses

Assets

- Non – Current Assets
  - Long Term Assets :

    Book value = Acquisition cost – Accumulated depreciation

    The firm reduces the value of fixed assets (other than land) over time according to a depreciation schedule that depends on the asset's life span.

  - Goodwill and Intangible Assets :

    If the firm assesses that the value of these intangible assets declined over time, it will reduce the amount listed on the balance sheet by an amortization or impairment charge that captures the change in value of the acquired assets.

  - Other Long - Term Assets (E.g. Investments in Long-Term Securities)

Assets, Liabilities & Equity and Income and Expenses

Liabilities

- In General Meaning Liabilities means what company owns
- Various types of Liabilities are mentioned below :
  - Long – Term Liabilities
  - Stockholder’s Equity

Assets, Liabilities & Equity and Income and Expenses

Liabilities

- Long – Term Liabilities :
  - Long – Term Debt
  - Capital Leases
  - Deferred taxes : Deferred taxes are taxes that are owed but have not yet been paid.

- Stockholder's Equity :
  - Book value of Equity

Book value of Assets – Book Value of Liabilities

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Income Statement

- Whereas the balance sheet shows the firm's assets and liabilities at a given point in time, the income statement shows the flow of revenues and expenses generated by those assets and liabilities between two dates.

- The income statement is sometimes called a profit and loss, or "P&L" statement, and the net income is also referred to as the firm's earnings.

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Assets, Liabilities & Equity and Income and Expenses

Income

- Revenue from operations :
  - Sale of product less returns
  - Sale of Services
  - Other operating revenues

- Other Income
  - Rent income
  - Dividend Income
  - Transfer fees
  - Profit on sale of Fixed Assets

Assets, Liabilities & Equity and Income and Expenses

Expenses

- Cost of Material Consumed
  - (Opening Stock + Purchases – Closing Stock).
- Changes in Inventories
  - (Opening Stock – Closing Stocks).
- Employee Benefit Expenses
  - Salary.
  - Staff Welfare Expenses.
- Finance Cost
  - Interests.
  - Discounts.
- Depreciations and Amortisation Expenses.

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Performance Analysis

Performance Analysis

Financial Performance

- One of the most fundamental facts about businesses is that the operating performance of the firm shapes its financial structure.
- It is also true that the financial situation of the firm can also determine its operating performance.

Performance Analysis

Measure of Financial Performance

- Return on Equity (ROE) :
  - The most popular measure of financial performance (for many audiences) is ROE.
  - ROE measures accounting earnings for a period per dollar of shareholders' equity invested.
  - ROE = Net Income / Shareholder's Equity

Performance Analysis

Measure of Financial Performance

- Profit Margin :
  - This ratio measures the fraction of each rupee of sales that makes it through to net income. (Net Income/Sales)
  - The "gross margin" measures profitability relative to variable costs. (Gross Profits/Sales)

Performance Analysis

Measure of Financial Performance

- Asset Turnover :
  - This ratio measures the sales generated per dollar of assets employed.
  - Asset turnover = Sales / Assets.
- Fixed Asset Turnover :
  - Fixed-Asset Turnover is perhaps a “purer” reflection of the capital intensity of a firm.
  - Fixed-Asset Turnover = Sales/Net Fixed Assets.

Performance Analysis

Measure of Financial Performance

- Financial Leverages :
  - Financial Leverage which is also known as leverage, refers the use of Debt to acquire additional Assets.
  - Financial Leverage = Assets / Shareholder’s Equity.
  - An increase in the value of the assets will result in a larger gain on the owner's cash, when the loan interest rate is less than the rate of increase in the asset's value.
  - A decrease in the value of the assets will result in a larger loss on the owner's cash.

Analysis of Capital Structure

CAPITAL STRUCTRE ANALYSIS

- Capital structure analysis is a periodic evaluation of all components of the debt and equity financing used by a business.
- The intent of the analysis is to evaluate what combination of debt and equity the business should have. This mix varies over time based on the costs of debt and equity and the risks to which a business is subjected.
- Capital structure analysis is usually confined to short-term debt, leases, long-term debt, preferred stock, and common stock

CAPITAL STRUCTRE ANALYSIS

Objectives for analyzing Capital Structure

- To determine if the proportion of debt to equity enables an entity to create wealth without unduly jeopardizing the firm.

- Capital structure composition
  - Consists of long-term liabilities, preferred stock, common stock, and retained earnings.
  - Sufficient equity must exist to provide financial stability
  - Debt can be used as leverage to increase returns to shareholders, but it can also reduce returns on shareholders' investments

CAPITAL STRUCTRE ANALYSIS

Capital Structure Measures

- Capital Structure Composition
- Financing activities should correspond to investing activities
- Lack of correspondence signals financial distress
- Common size statements

CAPITAL STRUCTRE ANALYSIS

Events where Capital Structure is must

- The upcoming maturity of a debt instrument, which may need to be replaced or paid off
- The need to find funding for the acquisition of a fixed asset.
- The need to fund an acquisition.
- A demand by a key investor to have the business buy back shares
- A demand by investors for a larger dividend
- An expected change in the market interest rate

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Cash Flow Analysis

Cash Flow Analysis

- It simply means studying or analysing the Cash Flow Statement comprising part of Financial Statements.
- It provides information about cash inflows and outflows during an accounting period.
- Is developed from Balance Sheet and Income Statement Data.
- Important as an Analytical Tool.

IMPORTANCE OF CASH FLOW

- Accrual-based accounting requires reporting revenues when earned and expenses when incurred- not when cash is exchanged.
- Explains the reasons for a change in cash.
- Reconciles net income with cash flow from operations.
- Valuation models used in financial analysis are often based on projection of future cash flows..

Preparing Cash Flow Statement

- Four Parts of a statement of cash flows:

- Cash
- Operating Activities
- Investing Activities
- Financing Activities

CASH

- Cash includes Cash and Cash-equivalents
- Cash Equivalents
- Treasury Bills maturing within 90 days or less.
- Investment Funds.
- Foreign Currency on hand
- Checking Account
- Free Savings Account

Operating Activities

- Cash flows related to selling goods and services; that is, the principle business of the firm.
- The cash effects of transactions and other events that enter into the determination of income.

Examples of Operating Activities

- Cash received from customers through sale of goods or services performed;
- Cash payments to suppliers or employees.
- Cash payment for taxes and other expenses.

Operating Activities

Cash Flow from Operating Activities	Amount (Rs.)	Amount (Rs.)
Cash Receipts from :		
Sales	XXX	
Commission & Fees	XXX	
Interest Received	XXX	
		XXX
Cash Payment for :		
Purchases	XXX	
Payments to and for employees	XXX	
Operating Expenses	XXX	
Interest Payments	XXX	
Direct Taxes Paid	XXX	
		XXX
Net Cash Flow from Operating Activities		XXX

Direct Method

Cash Flow from Operating Activities	Amount (Rs.)	Amount (Rs.)
Net Profit before Tax		XXX
Adjustment for :		
Depreciation	XXX	
Loss on Sale of Fixed Assets	XXX	
Loss on revaluation	XXX	XXX
Operating Profit before Working Capital Changes		XXX
Adjustment* for :		
Trade and other Receivables	XXX	
Inventories or Stocks	XXX	XXX
Trade Payments or (Creditors and B/P)		XXX
Cash Generated from Operations	XXX	XXX
Interest Paid	XXX	
Taxes Paid		
Net Cash Flow from Operating Activities		XXX

Indirect Method

Investing Activities

- Acquiring/disposing of securities that are not cash equivalents
- Cash flows related to the acquisition or sale of non-current assets.
- Lending money/collective on loans

Examples of Investing Activities:

- Cash received from sales of assets that are not held for the regular trading purposes such as sale of building; marketable securities such as trading and available for sale securities, and investments
- Cash payments to acquire property,plant, and equipment (PPE), other tangible or intangible assets, and other long term assets.
- Cash received from sale of, and paid for purchases of derivative instruments
-]

Cash flows from investing activities		
Sale of old equipment	₹	XXXX
Sale of van		XXXX
Sale of investment		XXXX
Purchase of land		(XXXX)
Purchase of new plant		(XXXX)
Purchase of building		(XXXX)
Net cash provided (or used) by investing activities	₹	XXXX

Financing Activities

- Borrowing from creditors/repaying the principal
- Obtaining resources from owners
- Providing owners with a return on investment

Examples of Financing Activities

- Cash received from issuing share capital
- Cash proceeds from issuing bonds, loans, notes, mortgages and other short or long-term borrowings
- Cash payments to shareholders to redeem exisiting shares-treasury stock
- Cash repayment of loans and other borrowings;and
- Cash payment to shareholders as dividends.

Cash flows from financing activities		
Issuance of common stock	₹	XXXX
Issuance of preferred stock		XXXX
Sale of treasury stock		XXXX
Payment of long-term loan		(XXXX)
Purchase of treasury stock		(XXXX)
Payment of dividends		(XXXX)
Net cash provided (or used) by financing activities	₹	XXXX

Limitations of Cash Flow Analysis

- Non- cash transactions are ignored
- Not a substitute for Income Statement
- Not a test for Total Financial Position
- Historical in Nature.

Analysis of Cash Flow

- When analyzing the cash outflows, the analyst should consider the necessity of the outflow and how the outflow was financed.
- Generally, it is best to finance short-term assets with short-term debt and long term-assets with long-term debt or issuance of stock.

Credit Analysis

Credit Analysis

- **Credit analysis** is the method by which one calculates the creditworthiness of a business or organization. In other words, It is the evaluation of the ability of a company to honor its financial obligations. The audited financial statements of a large company might be analyzed when it issues or has issued bonds. Or, a bank may analyze the financial statements of a small business before making or renewing a commercial loan. The term refers to either case, whether the business is large or small.

- The objective of credit analysis is to look at both the borrower and the lending facility being proposed and to assign a risk rating. The risk rating is derived by estimating the probability of default by the borrower at a given confidence level over the life of the facility, and by estimating the amount of loss that the lender would suffer in the event of default.

5C’s of Credit Analysis

- Character
- Capacity(Cash Flow)
- Capital
- Collateral (or Gurantees)
- Conditions

Character

- This is the part where the general impression of the protective borrower is analysed. The lender forms a very subjective opinion about the trust – worthiness of the entity to repay the loan. Discrete enquires, background, experience level, market opinion, and various other sources can be a way to collect qualitative information and then an opinion can be formed, whereby he can take a decision about the character of the entity.

Capacity

- Capacity refers to the ability of the borrower to service the loan from the profits generated by his investments. This is perhaps the most important of the five factors. The lender will calculate exactly how the repayment is supposed to take place, cash flow from the business, timing of repayment, probability of successful repayment of the loan, payment history and such factors, are considered to arrive at the probable capacity of the entity to repay the loan.

Capital

- Capital is the borrower's own skin in the business. This is seen as a proof of the borrower's commitment to the business. This is an indicator of how much the borrower is at risk if the business fails. Lenders expect a decent contribution from the borrower's own assets and personal financial guarantee to establish that they have committed their own funds before asking for any funding. Good capital goes on to strengthen the trust between the lender and borrower.

Conditions

- Conditions describe the purpose of the loan as well as the terms under which the facility is sanctioned. Purposes can be Working capital, purchase of additional equipment, inventory, or for long term investment. The lender considers various factors, such as macroeconomic conditions, currency positions, and industry health before putting forth the conditions for the facility.

Collateral(or Guarantees)

- Collateral are form of security that the borrower provides to the lender, to appropriate the loan in case it is not repaid from the returns as established at the time of availing the facility. Guarantees on the other hand are documents promising the repayment of the loan from someone else (generally family member or friends), if the borrower fails to repay the loan. Getting adequate collateral or guarantees as may deem fit to cover partly or wholly the loan amount bears huge significance. This is a way to mitigate the default risk. Many times, Collateral security is also used to offset any distasteful factors that may have come to the fore-front during the assessment process.

Credit Analysis Ratios

- A company’s financials contain the exact picture of what the business is going through, and this quantitative assessment bears utmost significance. Analysts consider various ratios and financial instruments to arrive at the true picture of the company.
- **Liquidity ratios** – These ratios deal with the ability of the company to repay its creditors, expenses, etc. These ratios are used to arrive at the cash generation capacity of the company. A profitable company does not imply that it will meet all its financial commitments.
- **Solvability ratios** – These ratios deal with the balance sheet items and are used to judge the future path that the company may follow.
- **Solvency ratios** – Solvency ratios are used to judge the risk involved in the business. These ratios take into picture the increasing amount of debts which may adversely affect the long term solvency of the company.

Credit Analysis Ratios

- **Profitability ratios** – Profitability ratios show the ability of a company to an earn a satisfactory profit over a period of time.
- **Efficiency ratios** – These ratios provide insight in the management's ability to earn a return on the capital involved, and the control they have on the expenses.
- **Cash flow and projected cash flow analysis** – Cash flow statement is one of the most important instrument available to a Credit Analyst, as this helps him to gauge the exact nature of revenue and profit flow. This helps him get a true picture about the movement of money in and out of the business
- **Collateral analysis** – Any security provided should be marketable, stable and transferable. These factors are highly important as failure on any of these fronts will lead to complete failure of this obligation.
- **SWOT analysis** – This is again a subjective analysis, which is done to align the expectations and current reality with market conditions.

THANK YOU!

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- Integrity
- Excellence
- Independence
- Confidentiality
- Competence