The Corporation

Lecture of Corporate Finance

SILESIAN UNIVERSITY
SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

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Outline of the lecture

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- The balance sheet model
- Financial statements
  - Balance sheet
  - Profit and Loss statement
  - Cash flow

The Balance Sheet model

Suppose we take a financial snapshot of the firm and its activities at a single point in time. Graphic conceptualization of the balance sheet would help introduce you to corporate finance. Balance sheet is divided into assets as well as liabilities, on the other side.

The assets of the firm are on the left side of the balance sheet. These assets can be thought of as current and fixed.

Fixed assets are those that will last a long time, like buildings. Some fixed assets are tangible, such as machinery and equipment. Other fixed assets are intangible, including patents and trademarks. The other category, current assets comprises those that have a short lives, such as inventory.

Before a company can invest in an asset, it first have obtain financing, which means that it must raise the money to pay for the investment. The forms of financing are represented on the right hand side of the balance sheet. A firm will issue (sell) pieces of paper called debt (loan agreements), or equity shares (stock certificates.

Assets & Liabilities

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Both assets and liabilities can be classified as long-lived or short-lived. A short-term debt is called a current liability. Short-term debt represents loans and other obligations that must be repaid within one year.

Long-term debt is debt that does not have to repaid within one year. Shareholders' equity represents the difference between the value of the assets and the debt of the firm. In this sense, it is a residual claim on the firm's assets.

The balance sheet model of the firm = why finance can be seen from these 3 questions:

- In what long-lived assets should the firm invest? (the answer = capital budgeting
- How can the firm raise cash for required capital expenditures? (via capital structure)
- How should short-term operating cash flows be managed? (via net working capital)

Financial Manager

In large firms, the financial activity is usually associated with a top officer of the firm, such as the vice president or **Chief Financial Officer** (CFO), and some lesser officers. It is called a general organizational structure emphasizing the finance activity within the firm.

Reporting to the CFO are the treasurer and controller. The **treasurer** is responsible for handling cash flows, managing capital expenditure decisions, and making financial plans.

The **controller**, on the other hand, handles the accounting function, which includes taxes, cost, revenues and financial accounting, as well as information systems

The Corporate Firm

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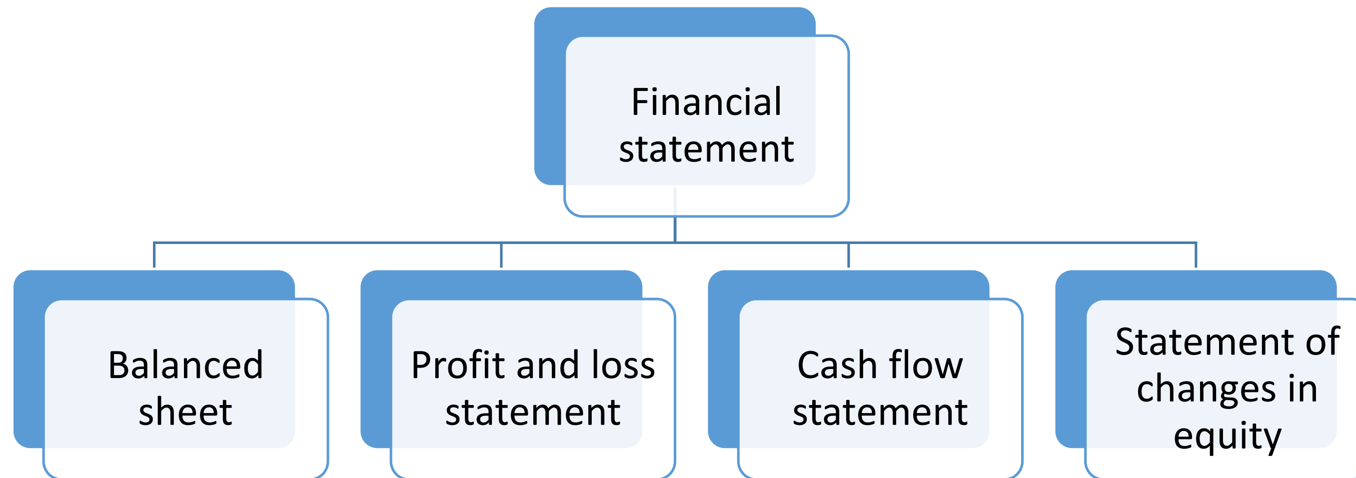
The firm is a way of organizing the economic activity of many individuals. A basic problem of the firm is how to raise cash. The corporate form of business-that is, organizing the firm as a corporation-is the standard method for solving problems encountered in raising large amounts of cash.

However, business can take other forms. We will distinguish between three basic forms of organizing firms, the sole proprietorship, the partnership, the corporation.

- The Sole Proprietorship
- The Partnership
- The Corporation

Financial statements

Financial Statements represent a formal record of the financial activities of an entity. These are written reports that quantify the financial strength, performance and liquidity of a company. Financial Statements reflect the financial effects of business transactions and events on the entity.



The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

Financial statement – consolidated, individual and separate

- **Consolidated financial statements** are the financial statements of a group of enterprises that combine the assets and liabilities and the results of the parent's holding with its interest in other entities that control or have a significant influence or controlling interest within the meaning of the Commercial Code, has significant or decisive influence.

  The objective of the consolidated financial statements is to provide the shareholders of the parent and the professional public with comprehensive information on the total assets, liabilities, equity, costs and revenues of the economic and economic groupings of the enterprises that are linked to the capital.

- **Individual (unconsolidated) financial statements** are compiled by enterprises that do not have subsidiaries to be consolidated.

- **Separate financial statements** are prepared by an enterprise at the request of an institution (for example, a country's accounting regulator) or by its own will.

Qualitative characteristics of financial statement

The **four principal qualitative characteristics** are:

- *Understandability* - it is essential that the information provided in financial statements is readily understandable by users. Users are assumed to have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information with reasonable diligence. Information on complex matters should not be omitted from financial statements merely on the grounds that some users may find it difficult to understand.
- *Relevance* - information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Information has a predictive role in helping users to look to the future. Predictive value does not necessarily require a forecast.
- *Reliability* - Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent.
- *Comparability* - means that users must be able to compare the financial statements of an enterprise over time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises to evaluate their relative financial position, performance and changes in financial position. Financial statements should show corresponding information for the previous period.

Objective and main reasons for preparing of financial statement

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- **The objective** of the financial statements is to provide information on the financial position, performance and changes in the financial position of the entity that are useful to a wide range of users in making economic decisions.

- **The main reasons** for the preparation of the financial statements are:
  - The liability to prepare the financial statements imposes legislation on the entity.
  - Presentation of the financial statements is a condition of the exchange in the issue of securities of the company.
  - An enterprise shall present its financial statements in public, in particular to shareholders / investors.

- Entities that are issuers of securities registered in a regulated securities market in the Member States of the European Union shall use the accounting and financial statements for the entity and the consolidated IFRS financial statements.

- Other entities must account for and prepare the financial statements for the entity in accordance with the Accounting Act and the related implementing regulation; For consolidated financial statements, IFRSs may be used instead of the Czech accounting rules in condition the Czech republic.

Supplements to the Financial Statements

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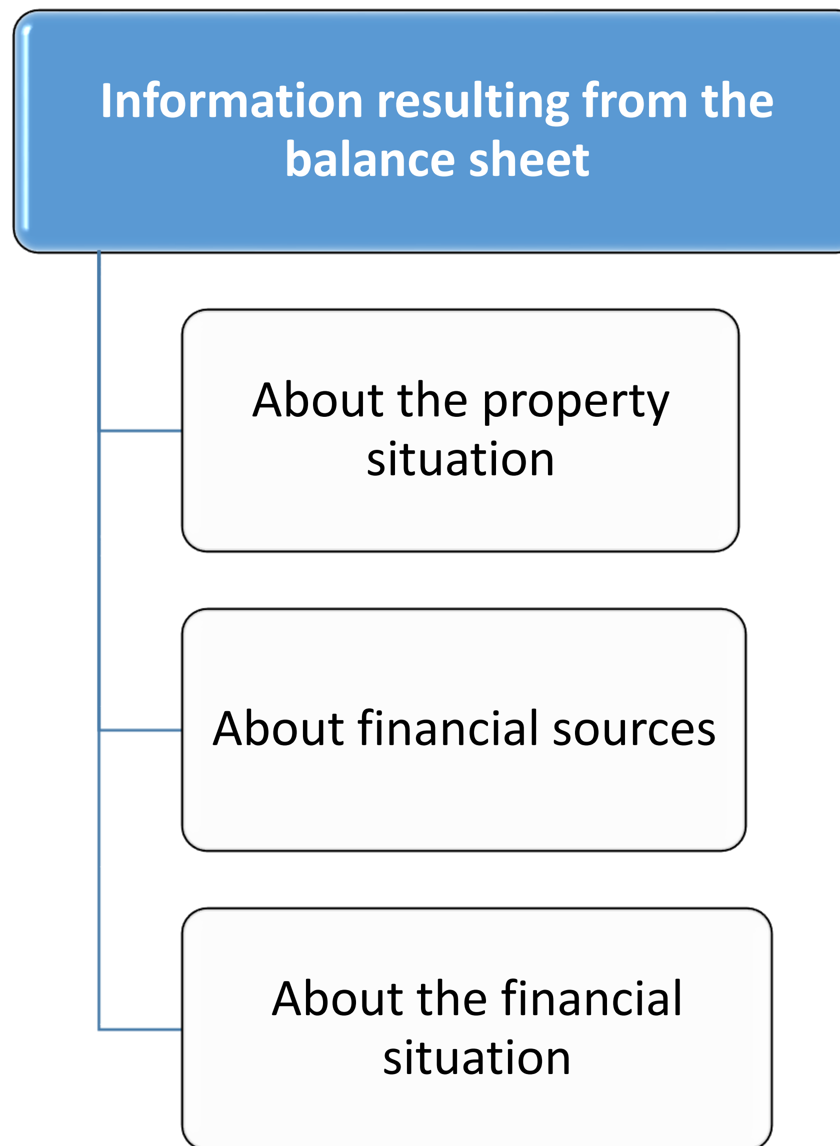
- Supplement to the financial statement
  - Relevant entity data
  - Information on accounting methods
  - Additional information to the balance sheet and profit and loss account
  - Cash flow statement

Balanced sheet

Statement of Financial Position, also known as the Balance Sheet, presents the financial position of an entity at a given date.

It is comprised of the following three elements:

- Assets: Something a business owns or controls
- Liabilities: Something a business owes to someone
- Equity: What the business owes to its owners.



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Assets

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An asset is something that an entity owns or controls in order to derive economic benefits from its use.

Assets must be classified in the balance sheet as current or non-current depending on the duration over which the reporting entity expects to derive economic benefit from its use.

Assets are also classified in the statement of financial position on the basis of their nature:

- *Tangible & intangible:* Non-current assets with physical substance are classified as property, plant and equipment whereas assets without any physical substance are classified as intangible assets. Goodwill is a type of an intangible asset.
- *Inventories balance* includes goods that are held for sale in the ordinary course of the business. Inventories may include raw materials, finished goods and works in progress. Trade receivables include the amounts that are recoverable from customers upon credit sales.
- *Trade receivables* are presented in the statement of financial position after the deduction of allowance for bad debts.
- *Cash and cash equivalents* include cash in hand along with any short term investments that are readily convertible into known amounts of cash.

Factors affecting the property structure

There are three main factors influencing the total assets of the company:

- Range of corporate performance,
- The total utilization rate
- Property price

Growth in corporate performance increases requirements for the size of assets at the same level of utilization and the same prices. Better use of property reduces the need for such property. The price change affects the amount of the total assets directly.

The property structure also depends on:

- *Technical difficulty of production* - affects the share of fixed tangible assets (technologically more demanding chemical or energy plants will have a share of fixed assets higher than those of the consumer industry or agriculture), but also the share of intangible and investment property in the form of license patents, Software, etc.
- *The development of the money and capital markets* - the impact on the financial assets of the company
- *Influenced by the specific economic situation of the enterprise and the orientation of its economic policy* (for example, the effort to secure a higher proportion of current assets is also reflected in the fact that fixed assets are acquired through leasing)

Financial structure

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The company's financial structure is the corporate capital structure from which the company's assets are financed. It is captured in balance sheet liabilities. **Liabilities** include:

- *equity* - equity, capital funds, profits/loss, past performance and current period economic results,
- *debt capital* - reserves, long-term and short-term liabilities and bank loans and debt
- *other liabilities* - in which accruals and deferred income, exchange rate differences, passive

The financial structure shows the structure of the increase in corporate capital from which the increase in assets is funded.

In addition to the term financial structure, there is also the concept of a capital structure - it captures the structure of corporate capital, from which fixed assets and a permanent part of the current assets are financed. It is therefore a structure of long-term capital. Within the financial structure, it is necessary to analyze especially the relationship between own and debt capital.

For an **optimal financial structure**, it considers a capital distribution that is linked to the minimization of all the costs of its acquisition and is in line with the expected revenue and profits and property structure of the enterprise.

Types of financial analysis of balanced sheet statement

- **Horizontal analysis** – trend analysis - evaluation of year-on-year development trend. The result as a percentage allows the comparison between enterprises.

$$\frac{(the\ value\ of\ balance\ sheet\ items\ in\ n-year)\ -(the\ value\ of\ balance\ sheet\ items\ in\ (n-1)-year))}{(the\ value\ of\ balance\ sheet\ items\ in\ (n-1)-year))*100}$$

- **Vertical analysis** – structure of assets, liabilities and equity - evaluation of asset structure and financial sources. Vertical analysis allows you to evaluate the structure of items in relation to the main business activity.

$$\frac{Balance\ sheet\ item}{Total\ assets}\ \text{x}\ 100$$

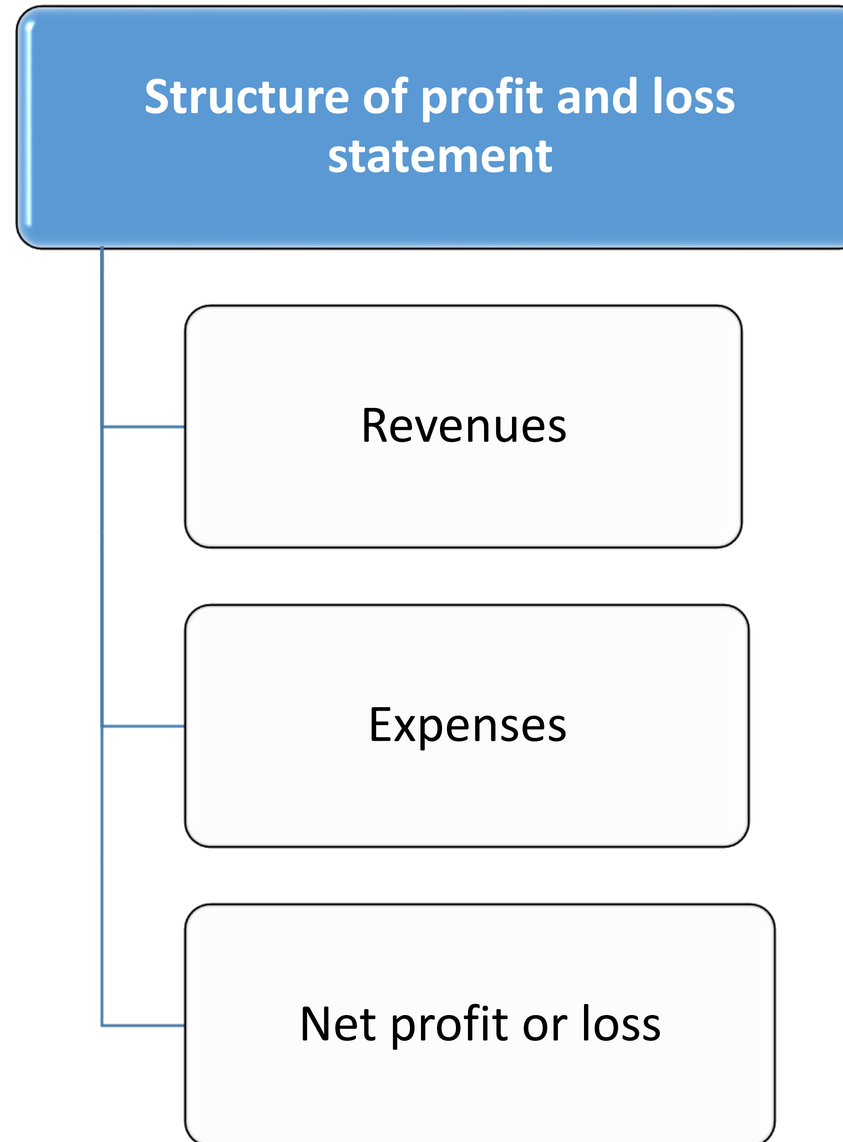
Problems with balance sheet analysis

The balance sheet describes the situation on the basis of historical prices, and it is precisely the pitfalls in terms of the information capabilities of the data:

- Displays the state of the values contained therein, **can not give information** about the company's **dynamics**;
- **does not work with the time value of money**; it does not affect exactly the present value of assets and liabilities
- An estimation must be used to determine **the realistic value** of some items, for example:
  - *actual quality of fixed assets* - the balance between the carrying amount and their current value;
  - *stocks* - there are important changes in the level of stocks between the periods and the causes of their change; It is mainly the relationship between the prices at which the stocks are valued and the actual prices, the interesting structure of the stocks and their adequacy in relation to the achieved performances;
  - *securities* - Recommend analysis of individual portfolio components; Prudence in relation to low-liquid securities;
  - *overstated receivables* - the creditworthiness of receivables;
  - *underestimated liabilities*.

Profit and loss statement

- Income Statement, also known as the *Profit and Loss Statement*, reports the company's financial performance in terms of net profit or loss over a specified period.
- The **income statement** is one of the major financial statements used by accountants and business owners.
- The profit and loss statement is important because it shows the profitability of a company during the time interval specified in its heading.



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Profit and loss statement - revenues

Revenue is defined as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants

Revenues from primary activities are often referred to as operating revenues. The primary activities of a retailer are purchasing merchandise and selling the merchandise. The primary activities of a manufacturer are producing the products and selling them. For retailers, manufacturers, wholesalers, and distributors the revenues resulting from their primary activities are referred to as sales revenues or sales. The primary activities of a company that provides services involve acquiring expertise and selling that expertise to clients.

It's critical that you don't confuse revenues with receipts. Under the accrual basis of accounting, service revenues and sales revenues are shown at the top of the income statement in the period they are earned or delivered, not in the period when the cash is collected. Put simply, revenues occur when money is earned, receipts occur when cash is received.

Revenues from secondary activities are often referred to as non-operating revenues. These are the amounts a business earns outside of purchasing and selling goods and services. For example, when a retail business earns interest on some of its idle cash, or earns rent from some vacant space, these revenues result from an activity outside of buying and selling merchandise. As a result the revenues are reported on the income statement separate from its primary activity of sales or service revenues.

Profit and loss statement - expenses

Expenses involved in primary activities are expenses that are incurred in order to earn normal operating revenues. Under the accrual basis of accounting sales commissions expense should appear on the income statement in the same period that the related sales are reported, regardless of when the commission is actually paid. In the same way, the cost of goods sold is matched with the related sales on the income statement, regardless of when the supplier of the merchandise is paid.

The income statements or profit and loss statements of merchandisers and manufacturers will use a separate line for the cost of goods sold. The other expenses involved in their primary activities will either be grouped together as operating expenses or subdivided into the categories "selling" and "administrative".

Expenses from secondary activities are referred to as non-operating expenses. For example, interest expense is a non-operating expense because it involves the finance function of the business, rather than the primary activities of buying/producing and selling.

Types of costs

Fixed costs

- Costs independent of the quantity produced

Variable costs

- Costs dependent on the quantity produced

Indirect costs

- Costs that can not be assigned directly to a particular performance
- It is necessary to budget them in a certain way

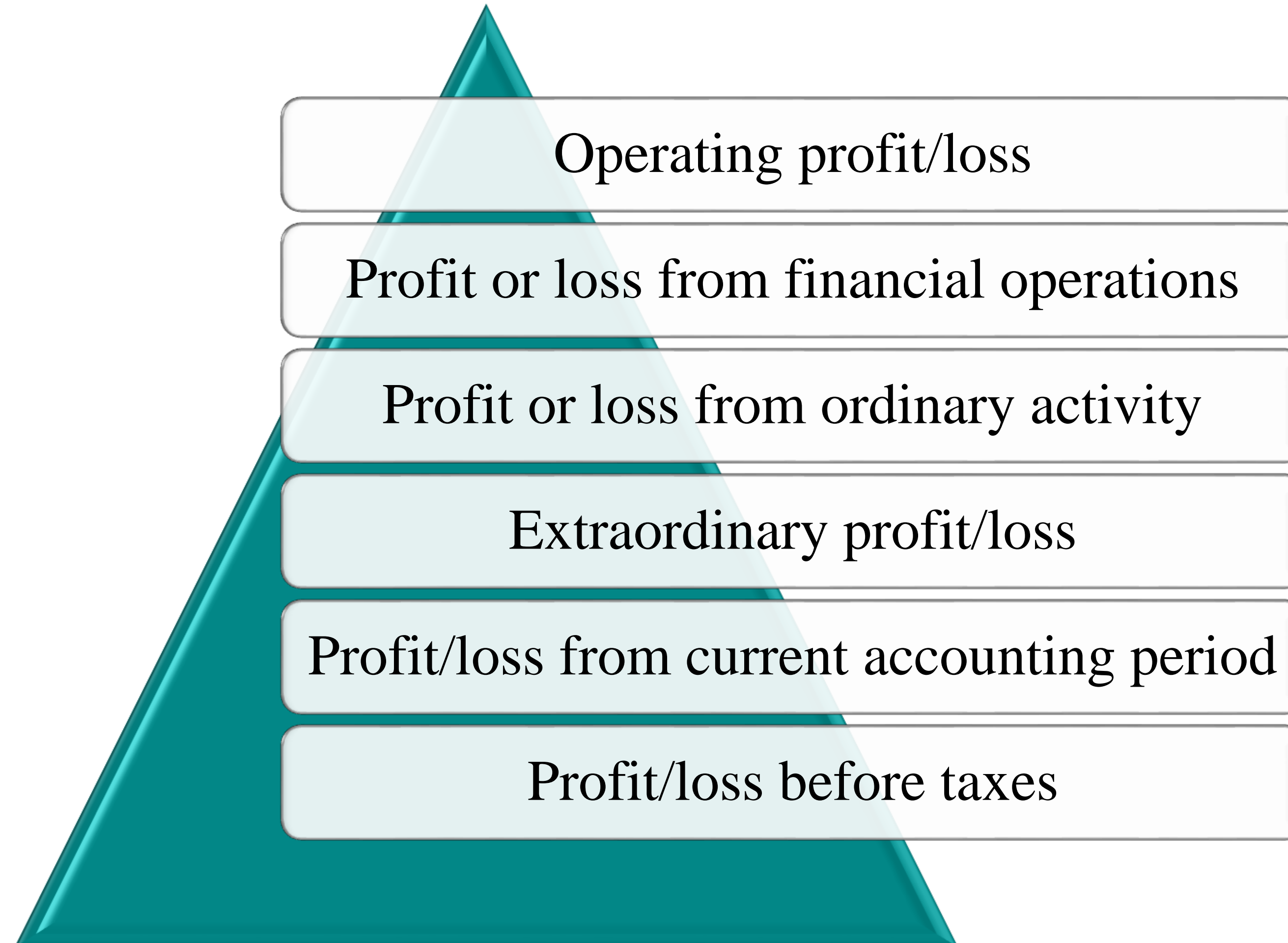
Marginal costs

- The cost of the last produced unit
- An increase in the total cost of producing one extra product

Opportunity costs

- The cost of sacrificing opportunities

Types of economic results



Profit and loss statement – using and problems

The P&L statement is used by businesses in three ways:

- ***As one of the financial statements in a business plan,*** for the purpose of showing profits of the business over time. In this case, the P&L statement might be a pro forma (projected) document, for an application for a startup business loan.
- ***As a tool for internal analysis*** of the health of the business. As described above, the percentages of each expense to the gross income are useful in analysis. In other ways, some P&L statements compare figures for sales and expenses to budgeted figures, to show whether projected goals have been met.
- ***As a tool for taxes.*** A detailed P&L statement is prepared for an entire year, ending at the date of the end of the fiscal (financial) year, and it is used by the tax preparer to compile the income and expenses for the business tax return.

Problems associated with the profit and loss statement:

- Contains flow variables;
- Revenues earned over a certain period and the associated costs may not be incurred in the same period - accruals and deferred income;
- Cost and revenue items do not rely on actual cash flows.

Cash flow statement

- The statement of cash flows is one of the financial statements issued by a business, and describes the cash flows into and out of the organization.
- Its particular focus is on the types of activities that create and use cash, which are operations, investments, and financing.
- It is especially useful when there is a divergence between the amount of profits reported and the amount of net cash flow generated by operations.

Areas of cash flow statement

- Operating activities
- Financial activities
- Investing activities

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Areas of cash flow statement

Cash flow statement, when used in conjunction with the rest of the financial statements, provides users with information on solvency and liquidity. It shows how cash is generated in the business and helps users to understand how much flexibility is available to adapt to changing circumstances and opportunities.

- *Operating activities*. These constitute the revenue-generating activities of a business. Examples of operating activities are cash received and disbursed for product sales, royalties, commissions, fines, lawsuits, supplier and lender invoices, and payroll. Cash flow from operating activities allows to determine to what extent profit from ordinary activities to truly earned money and how money influenced the production of changes in working capital and its components.
- *Investing activities*. These constitute payments made to acquire long-term assets, as well as cash received from their sale. Examples of investing activities are the purchase of fixed assets and the purchase or sale of securities issued by other entities. The investment area shows us not only the expenses related to the acquisition of investment property and the structure of these expenses, but also the extent of the proceeds from the sale of investment property, which is reported precisely in this financial statement.
- *Financing activities*. These constitute activities that will alter the equity or borrowings of a business. Examples are the sale of company shares, the repurchase of shares, and dividend payments.

Thank you for your attention!