Financial accounting and analysis notes

- **Why report cash flows**

  To satisfy objectives of financial reporting:

  Key information to take economic decisions

  Management's stewardship

  Cash is essential to business survival!

  Profitable / liquid = success

  Unprofitable / liquid = possible success

  Profitable / illiquid = likely to fail

  Unprofitable / illiquid = failure

  Cash is objective (?)

  → More reliable than profit

  Reliability = key characteristic of useful information

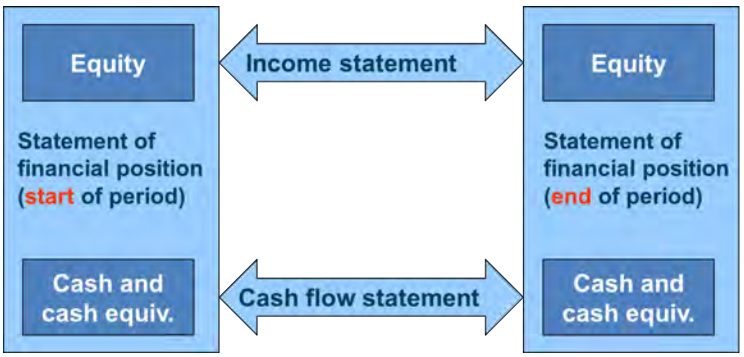
- **The statement of cash flows**

  It summarises the inflows and outflows of cash and cash equivalents for a business over a period.

  Can we find this information in the other 2 main statements?

  What if I compare the statements of financial position of two consecutive periods?

- **Relationship between the main financial statements**



changes in the fair value of investment properties and financial instruments;

penalties and fines imposed by regulatory bodies and courts;

legal costs related to a failed acquisition attempt;

redundancy expenses and restructuring charges from a large-scale cost-cutting exercise.

Where companies have reported one-off gains and losses (e.g. arising from disposal of a fixed asset), (a) work out where they have been reported and restate the Income Statement to (b) exclude these items.

Analyst needs to read the notes very carefully as it is not always easy to find these disclosures.

Most gains are reported in “other income” and losses in “other expenses”.

A few items (e.g. gains and losses from changes to defined pension plan terms), may be included in cost-of-sales.

Reverse gains and losses and recalculate derived line item

Adjustments to interest income/expenses

Add back capitalised interest to interest expense.

Reverse interest expense from defined benefit pension plans and add to expenses.

Add any dividends on preferred stock to interest expense.

- **Key categories of ratios**

  Financial ratios…

  Financial gearing (financing decisions)

  Liquidity (asset management)

  Efficiency (asset management)

  Profitability (operations management)

  Investment (dividend policy)

- **Return on equity (ROE)**

$$= \frac{\textbf{Profit after tax}}{\textbf{Equity}}$$

Measures cents of net profit generated for every $ of equity invested

Expressed as a %

- **Working capital turnover ratios**

Trade receivables turnover = revenue / trade receivables

Inventory turnover = cost of sales / inventory

Trade payables turnover = purchases (or cost of sales) / trade payables

- **Cash convention cycle days**

Cycle days = Days inventory outstanding
+ Days sales outstanding
– Days purchases outstanding

Measure number of days between firm paying its suppliers and receiving cash from its customer

Number varies by industry – no 'right' value

Shorter the cycle the less money tied up in working capital

When this number is negative represents number of days between receiving cash from customers and having to pay suppliers

- **Inventory days**

Inventory days increasing

STOCK-PILING

Sales lower than expected? – likely explanation most of the time

Preparation for run up to a sales period? – not an explanation if the increase is yoy (year over year)

Other possibilities: anticipated shortage (e.g power station stockpiling coal before expected disruption to supplies), discount for buying in bulk?)

Inventory days falling

INVENTORY BEING RUN DOWN

Better than expected sales?

Better stock management – new stock control system?

Reduction in an unwanted stock build-up?

Problems with supplies? Shortages?

Problems with paying for supplies?