Financial Statements Analysis

- Income Statement
- Balance Sheet
- Cash Flows

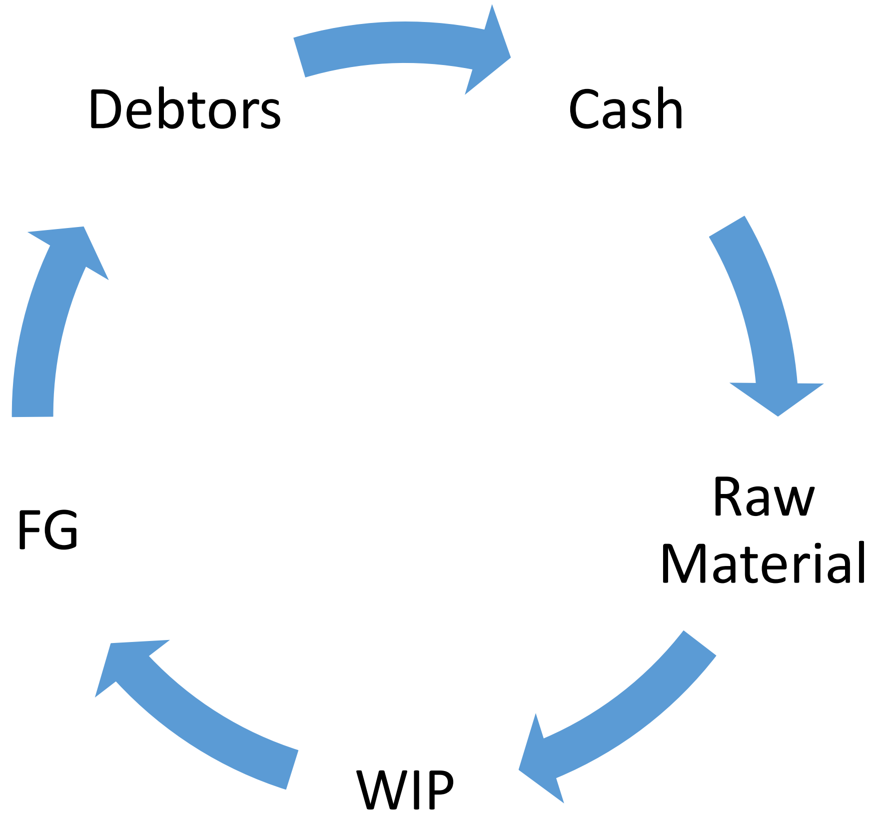
Cash Flow Statement

- Cash flow statement is a statement which indicates sources of cash inflows and transactions of cash outflows of a firm during an accounting period.
- The activities which generate cash inflows are known as sources of cash and activities which cause cash outflows are known as uses of cash.
- It is appropriately termed as " where got where gone statement."

Cash Flow Statement

- Cash is the most liquid of assets and offers a company both liquidity and flexibility. It is both the beginning and the end of a company’s operating cycle.

Operating Cycle



Purpose of CFS

- The purpose of cash flows is to provide information on cash inflows and outflows for a period. It also distinguishes among the sources and uses of cash flows by separating them into operating, investing, and financing activities.

- Analysis of CFS helps us in assessing liquidity, solvency and financial flexibility.
- Liquidity is the nearness to cash of assets and liabilities.
- Solvency is the ability to pay liabilities when they mature.
- Financial flexibility is the ability to react and adjust to opportunities and adversities.

Operating Activities

- Cash flows from operating activities primarily accrue from the major revenue producing activities (i.e. income statement items) and balance sheet items relating to operations- usually working capital accounts like receivables, inventories, prepayments, payables, and accrued expenses.

Investing Activities

- Investing activities are means of acquiring and disposing of noncash assets.

- These activities involve assets expected to generate income for a company, such as purchases and sales of PPE and investment in securities.

- They also include lending funds and collecting the principal on these loans.

Financing Activities

- Financing activities are means of contributing, withdrawing, and servicing of funds to support business activities.

- They include borrowing and repaying of funds with bonds and other loans.

- They also include contributions and withdrawals by owners and their return (dividends) on investment.

Free Cash Flow

- Cash flows from operations
- -Net capital expenditures required to maintain productive capacity
- -Dividend on preferred stock and common stock(assuming a payout policy)
- **Free Cash Flow(FCF)**

Another concept of Free Cash Flows

- FCF=NOPAT-Change in NOA.
- This definition defines free cash flows to the firm as net operating profits after tax (NOPAT) less the increase in net operating assets(NOA).
- The increase in NOA subsumes the change in working capital for net cash flows from operations and the increase in long-term operating assets(similar to the second line in the formula presented in the previous slide).

Contd.

- Positive free cash flow reflects the amount available for business activities after allowances for financing and investing requirements to maintain productive capacity at current levels.
- Growth and financial flexibility depend on adequate free cash flow.

Income statement: An income statement measures a company's financial performance between balance sheet dates. It is a representation of the operating activities of a company.

- The main purpose of income statement is to explain how income is determined, with its important components reported as separate line items.

- Revenues (and gains) and expenses (and losses) are the two major components of accounting income.

Revenues and Gains

- Revenues are earned inflows or prospective earned inflows of cash that arise from a company's ongoing business activities. These include cash inflows such as cash sales, and prospective cash inflows such as credit sales.

- Gains are earned inflows or prospective earned inflows of cash arising from transactions and events unrelated to a company's ongoing business activities.

Balance Sheet

- Balance sheet is statement which reflects a company's financial position at a particular point of time.
- It is prepared with the Real and Personal accounts appearing in the Trial Balance of the concern.
- It is prepared to show the financial position of the company on a specific date. It reflects the financial health or condition of the business on that date.
- It is further used by the users for financial analysis of the concern.

Contd.

- The distinction between revenues and gains is based on the ongoing business activities that produce revenues.
- Revenues are expected to persist indefinitely for a going concern. In contrast, gains are nonrecurring.

Expenses and Losses

- Expenses are incurred outflows, prospective outflows, or allocations of past outflows of cash that arise from a company’s ongoing business operations.

- Losses are decreases in company’s net assets arising from peripheral or incidental operations of a company.

Earnings Per Share(EPS) measures the profit available to equity shareholders on a per share basis.

- EPS=$\frac{Net\ profit\ available\ to\ equity-holders}{No.of\ ordinary\ shares\ outstanding}$

- **Always compare (i) the past records of the same firm (ii) inter-firm comparison (iii) comparison with the overall industry average.

Cash Earnings Per Share is computed using cash flows from business operations as the numerator. The ratio indicates the cash generating ability (per equity share) of the firm.

- Cash EPS=$\frac{Net\ profit\ available\ to\ equity\ owners+Depreciation+Amortization+Non-cash\ expenses}{No.of\ ordinary\ shares\ outstanding}$

Book Value per Share represents claim of the equity shareholder on a per share basis.

- Book Value Per Share=$\frac{Net\ Worth}{No.of\ equity\ shares\ oustanding}$

- Net Worth=Equity share capital + reserves and surplus-accumulated losses.

Price-to-Book Value Ratio: Also known as Price to book(P/B)ratio, measures the relationship between the market price of an equity share (MPS) with book value per share(BPS)

- P/B Ratio=$\frac{MPS}{PBS}$

- P/B ratio is significant in predicting future stock returns.

Price Earnings (P/E) ratio measures the amount investors are willing to pay for each rupee of earnings; higher the ratio, larger the investors confidence in the firm's future.

- P/E ratio=$\frac{Market\ price\ per\ share}{EPS}$

Dividend pay-out(D/P) ratio also known as pay-out ratio measures the proportions of dividends paid to earning available to shareholders.

- D/P ratio=$\frac{Tolal\ dividend\ (cash\ dividend) to\ equityholders}{total\ net\ profit\ belonging\ to\ equityholders}$x100

Other ratios:

- Dividend per Share(DPS)=$\frac{Dividend\ paid\ to\ ordinaryshareholders}{No.of\ ordinary\ shares\ outstanding}$

- Earnings Yield=$\frac{EPS}{MPS}$x100

- Dividend Yield=$\frac{DPS}{MPS}$x100

Thank You