

Financial Reporting and Analysis

* **Financial reporting:** It is the way companies show their performance information to the public.
* **Financial Statement Analysis (FSA):** The role of FSA is to use the company’s financial statements and other relevant information to make economic decisions as well as draw the comparison in context with the current environment situations and similar companies in the industry.
  1. **FSA is used to –**
     + Evaluate company’s ongoing financial position and performance in the past; and
     + Project company’s ability to earn profits and future cash flows.
  2. **So that economic decisions like the following can be taken –**
     + Whether to invest in the company's securities
     + Whether to extend bank credit to the company
     + Which company is the right choice for M&A
     + What is the credit rating of a company or debt issue

## While profitability is an important parameter, cash flows are more critical because –

* + Company needs to pay cash to employees, suppliers, etc.
  + Provides flexibility in funding capex for business opportunities
  + Helps in serving debt (to pay interest) and equity (pay dividend)
  + **Liquidity:** Ability to meet **short-term** obligations
  + **Solvency:** Ability to meet **long-term** obligations
* Information is collected based on the decision to be made.
* Besides data provided by the company, the analyst also collects loads of information from other sources.

Other Sources

External auditor’s report

Management Disclosure and Analysis (MD&A)

Financial notes and Supplementary Schedules

Financial statements at regular intervals

**Sources of Information**

1. Determine Objective

and Context

2. Gather Data

3. Process the Data

6. Follow-up and update the Analysis

5. Report the Conclusions or

Recommendations

4. Analyze and interpret the data

## Determine Objective and Context –

* Must have a clear understanding of objectives to identify data and the methodology to be used
* Some tasks are well-defined and easy (periodic credit review) while others might not be
* Analyst might be lured to start data punching and calculating ratios without knowing the relevance
* Analyst should make a list of questions to be answered through analysis

|  |  |
| --- | --- |
| **Stakeholder** | **Objective** |
| Lender | Credit worthiness |
| Investor | Returns from the investment |
| Supplier | Liquidity Position |
| Customer | Sustainability of operations |
| Capital Markets | Corporate Governance |
| Government | Revenue generation ability |
| Employees | Impact on wages/salaries |

## Collect data –

* + Should have a clear understanding of company’s business and financial position
  + Along with financial statements, additional information might be required and
  + Top-down approach is followed (i.e., start with broad economy and drill down to company level)

## Process the Data –

* + Requires various analytical tools such as Ratio Analysis, Common-size statements (discussed later)
  + Requires adjustment to financial statements for a like-to-like comparison

## Analyze and Interpret Data –

* + Along with quantitative results, analyst should provide interpretation and qualitative comments
  + So, conclusion or recommendation is important.

## Report Conclusions or Recommendations –

* + Research report could talk about valuation, estimates, risk, historical data, etc.

## Follow-up and Update the Analysis –

* + Periodic review is required and might involve going through all the previous steps and
  + Necessary adjustments are made

* Financial reporting standards are set by International Accounting Standards Board (IASB).
* Standards are expressed in 'Conceptual Framework for Financial Reporting 2010’.
* Updated framework now extends to **financial reporting**, rather than **financial statements** only.
* It identifies **primary users** who might be interested in a particular report rather than **wide users.**
* It identifies the information to be reported on financial position, performance, and economic resources.
* Judgement is required while reporting some transactions, as the standards should drive some consistency.
* There is a clear distinction between **Standard Setting Bodies** (IASB, FASB) versus **Regulatory Authorities** (SEC).
* While Standard Setting Bodies establish the financial reporting standards, Regulatory Authorities have the legal authority to enforce these standards.
* Unless Standards are recognized by Regulatory Authorities, Standard Setting Bodies have no value.
* Standard Setting Bodies can have different views compared to that of the regulators.

## Accounting Standards Board –

* + Generally private and independent; non-profit organization
  + Objective is to act in public interest
  + Strong ethical standards such that decisions are not influenced by external forces
  + International Accounting Standards Board **(IASB):** Issues International Financial Reporting Standards

**(IFRS)**

* + US Financial Accounting Standards Board **(FASB):** Issues US Generally Accepted Accounting Principles **(US GAAP)**

## Regulatory Authorities –

* + Government entities with legal authority to enforce standards
  + Regulators might either specify **one specific set** of standards, or **acceptable sets** of standards
  1. **International Organization of Securities Commissions (IOSCO) –**
     + Not a regulatory authority, but its members regulate many financial markets (more than 95%). Ensures

**cross-board coordination to minimize violation**

* 1. **Capital Markets Regulation in Europe –**
     + **European Securities Committee (ESC):** Advises European Commission on **securities policy issues**
     + **Committee of European Securities Regulators (CESR):** Assists in **technical issues**
  2. **Securities and Exchange Commission (SEC) –** One of the most developed and oldest regulatory body with primary responsibility of regulating securities and capital markets in the US:
     + **Securities Act of 1933:** Specifies financial and other information to be provided to investors while prohibiting misrepresentations
     + **Securities Exchange Act of 1934:** Empowered SEC to **require periodic reporting** by public companies
     + **Sarbanes Oxley Act of 2002:** Management is required to provide a report on **internal control system** and addresses auditor independence

## Filings required by SEC:

* **Form S-1:** Registration statement filed prior to the sale of new securities to the public.
* **Annual forms such as Form 10-K** for the US, 40-F for Canada or 20-F for non-US: Disclosure about business and its management, audited financial statements, legal matters, etc.
* **Annual report:** Not an SEC requirement; marketing document to shareholders and external parties.
* **Interim reports (Form 10-Q** is quarterly for the US and **6-K** is half-yearly for non-US): Financial statements (which may not be audited), and MD&A.
* **Form DEF-14A:** Proxy statement for its shareholders prior to the annual meeting or other shareholder vote.
* **Form 8-K:** Filed to disclose material event like Acquisitions and disposals, changes in corporate governance.
* **Form 144:** When a company issues securities without registering the securities with the SEC.
* **Form 3,4,5:** Details on beneficial ownership of securities by company's officers and directors.
* **Form 11-K:** Annual filing summarizing employee stock purchase, savings and other plans.

**Reporting Elements**

Qualitative Characteristics

Objective

To Provide Financial Information Useful in Making Decisions about Providing Resources to the Entity

* **Relevance\***  **Comparability,**
* **Faithful Representation Verifiability,**

**Timeliness, Understandability**

* **Performance**
  + **Income**
  + **Expenses**
  + **Capital Maintenance Adjustments**
  + **Past Cash Flows**

Underlying Assumption

* Accrual Basis
* Going Concern

Constraint

* Cost (cost/benefit consideration

## Objective of Financial Reports –

* + Should help in decision-making process
  + While some information is required by all, individual users might require unique information
  + Provide information to assist in analyzing the future cash flows and estimating valuation of entity

## Qualitative Characteristics of Financial Reports –

* + Fundamental Characteristics:
    - **Relevance:** Information that could decision
    - **Faithful presentation:** Should be complete, unbiased, and error-free
  + Characteristics that enhance fundamental characteristics:
    - **Comparability:** Should be consistent over time and across entities
    - **Verifiability:** Expert outsiders can confirm information provided
    - **Timeliness:** Information should be available before an investor has to make a decision and
    - **Understandability:** Should be clear and concise

## Constraints on Financial Reports –

* + Cost of providing and using information (cost benefit analysis)
  + Financial Statements could omit qualitative information (customer loyalty, work force quality)

## Elements of Financial Statements –

* + **Assets:** Resources of the firm due to past events from which economic benefits are expected
  + **Liabilities:** Current obligations due to past events, settlement of which expected an outflow
  + **Equity:** Residual interest which is equal to Assets–Liabilities
  + **Income:** Includes revenue and gains; result of past transaction which accrued economic benefits either by way of increasing assets, or decreasing liabilities
  + **Expenses:** Includes expenses and losses; result of past transaction, which accrued economic costs either by way of decreasing assets, or increasing liabilities

## Basic Accounting Assumptions –

* + **Going Concern:** Business is expected to continue forever
  + **Accrual:** Records transaction when they are done rather than when the associated cash flow takes place
* An item is recognized in Financial Statements if it is:

1. **Probable**
2. **Measured with reliability**

* IASB and FASB consider frameworks from other countries to develop a joint framework.
* However, there will still be issues in converging to IFRS.
* Many differences in IFRS and US GAAP that affects reporting requirements:
  + **Performance Elements:** Along with Revenue and Expenses, FASB considers Gains, Losses and Comprehensive Income
  + **Financial Position Elements:** Assets is **source of economic benefits** under IASB and is an

**economic benefit itself** under FASB

* + **Recognition of Elements:** FASB uses the word **probable** for assets/liabilities, unlike IASB
  + **Measurement of Elements:** FASB does not allow to adjust the values of most assets upwards

## Comparison of IFRS and Alternative Reporting Systems –

* + Significant differences in financial reporting under various systems
  + Reconciliation of Net Income and Shareholder’s Equity as per IFRS is an effective fix
  + If Reconciliation is not available, analyst must be aware of difference in reporting standards
  + However, an analyst would not have enough data to make adjustments for the like-to-like comparison

## Monitoring Developments in Financial Reporting Standards –

* + **New Types of Transactions:** There might be no explicit guidance available at initial stage, but as more and more companies start reporting it, becomes easy to gain understanding.
  + **Evolving Standards:** Changes in regulations can impact financial reporting and hence, the valuation. Therefore, it is critical to be updated on these standards.
  + **Company Disclosures:** MD&A discusses accounting policies where significant judgement and estimation was required. However, Footnotes discuss all accounting policies, even if no judgement was required. Also, companies must disclose change in accounting policies.
* As Revenue Recognition varies globally, comparison of revenue becomes challenging.

## Therefore IASB & FASB issued a converged accounting standard in May 2014.

* It introduces some changes to the principles of revenue recognition to enhance comparability.
* It provides a principles-based approach to be applied to many revenue generating activities.

## The 5 steps in recognizing revenue –

1. Identify the contract(s) with a customer.
2. Identify the separate or distinct performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

**Contract –** As per the standard, a contract is an agreement between two or more parties that specifies their obligations and rights. . Collectability must be probable for a contract to exist, but “probable” is defined differently under IFRS and U.S. GAAP so an identical activity could still be accounted for differently by IFRS and U.S. GAAP reporting firms.

**Performance Obligation –** A promise to deliver a distinct good or service, where the customer can benefit from the good or service on its own or combined with other resources that are already available.

**Transaction price –** the amount that a form expects to receive from a customer in exchange of the goods or services provided to the customer. The transaction price can be fixed or variable.



Thank You!

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