

Fall 2008
International Corporate Finance I

LECTURE 2
Reading Financial Statements

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8/22/2008

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Financial statements

- Flow vs stock
 - Household: Income - spending (flow)
 - Wealth (stock)
- Corporation
 - Flow:
 - income statement: revenue and expenses throughout the year.
 - The statement of cash flow: lists underlying transactions that caused the cashflows.

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Balance sheet (stock)

- A snapshot of what the firm owns and what the firm owes at the end of the year.
- *Assets (including cash)*
- *Liabilities*: Outside claims to the firm's assets, except shareholders.
- *Stockholders' equity (Capital)*
- *Equity = Assets - Liabilities*

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$$\textit{Equity} = \textit{Assets} - \textit{Liabilities}$$

A**L**

- Assets

- Liabilities

- Equity

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Globalization of accounting standard

- Used to be: single firm
 - Today: consolidated
 - Group firm and subsidiaries
 - Potential assets and debts

- English or local language (about Japanese firms)
 - Most of major Japanese firms publish *Annual Reports* in English.

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Example: Daikin's Annual Report 2007

Consolidated balance sheets (p.28&29)

- ASSETS (p.28)
 - Current assets **46.5%**
 - Cash and short-term securities
 - Receivables
 - Inventories
 - Property, plants, and equipment **20.4%**
 - Investments and other assets **33.1%**
 - Financial assets (group firm stocks) **100%**
 - Goodwill

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Daikin's Annual Report 2007

- Liabilities (p.29)
 - Current liabilities **54.8%**
 - Short-term borrowings
 - Payables
 - Long-term liabilities **9.7%**

- Equiy **35.5%**
 - Common stocks **100%**
 - Retained earnings
 - Capital surplus

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Statement of Income (p.30)

- Income = Revenues – Expenses
- Details
 - Net sales – Cost of Sales – Operation Costs
= **Operating Income**
 - **Operating Income** + **Other Income**
= **Income before Tax**
 - Other income = interest income – interest payments + other financial adjustments
 - **Income before Tax** – Corporate Tax = **Net income**
 - **Net Income** – Dividend Payments = Retained earnings

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Consolidated Statements of Changes in Equity (p.31)

- *Balance at the beginning of the fiscal year*
- Within the year changes
 - + Net income
 - Dividend payments and other payments to shareholders (such as share repurchases)
- *Balance at the end of the fiscal year*

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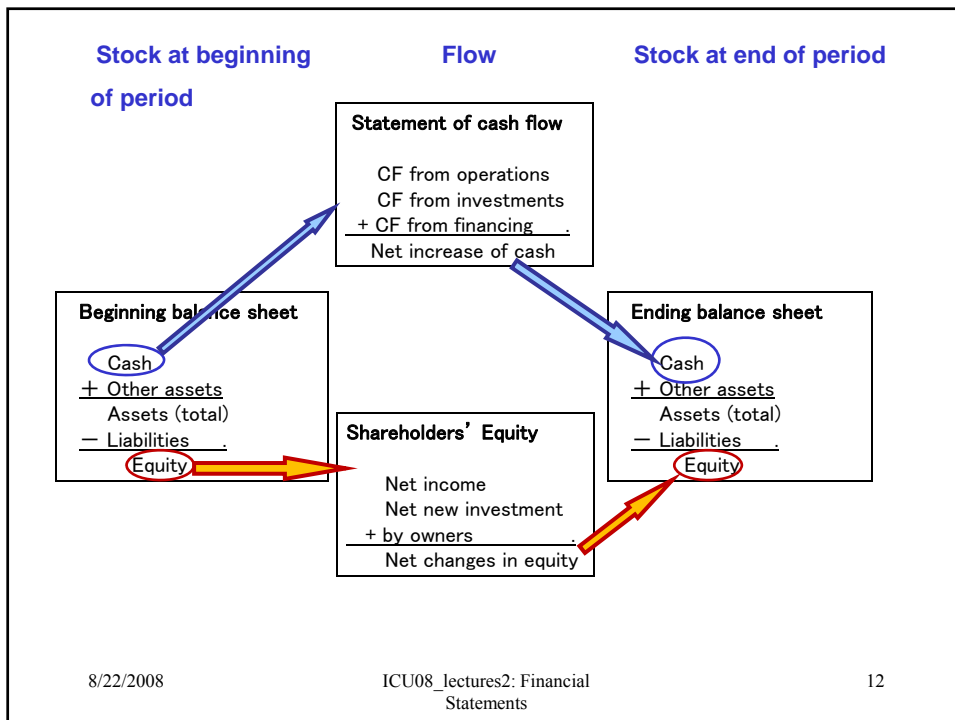
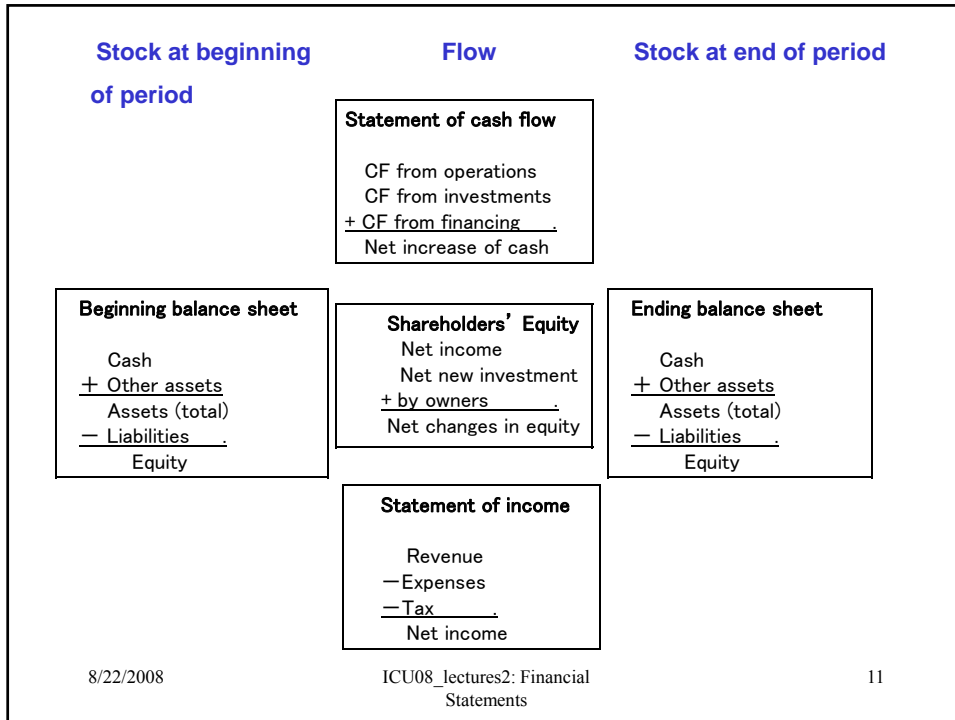
Consolidated Statements of Cash Flows (p.32)

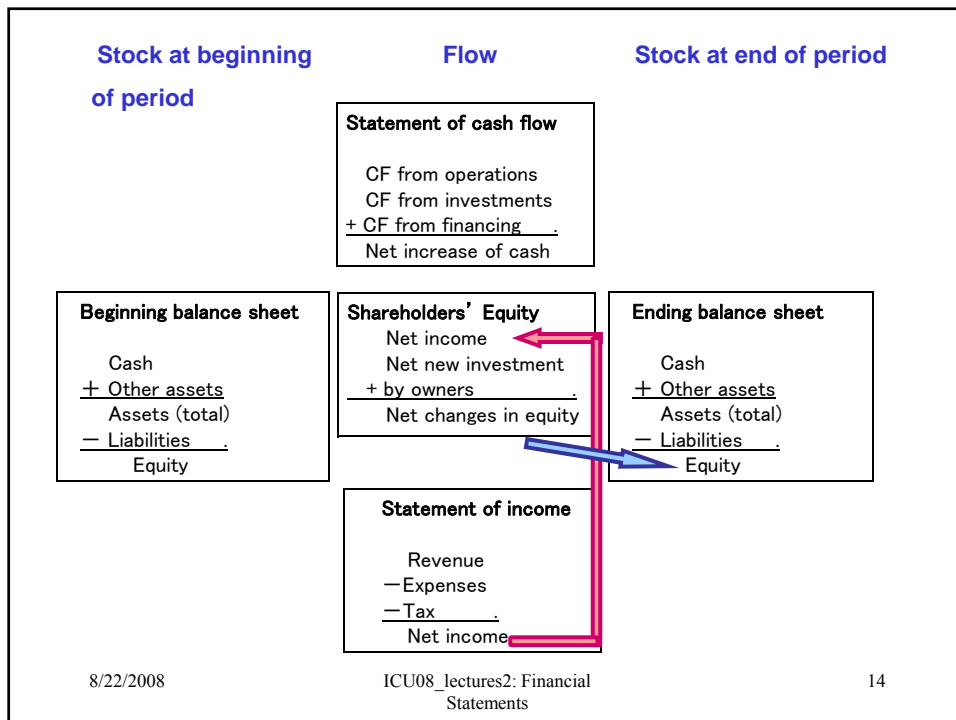
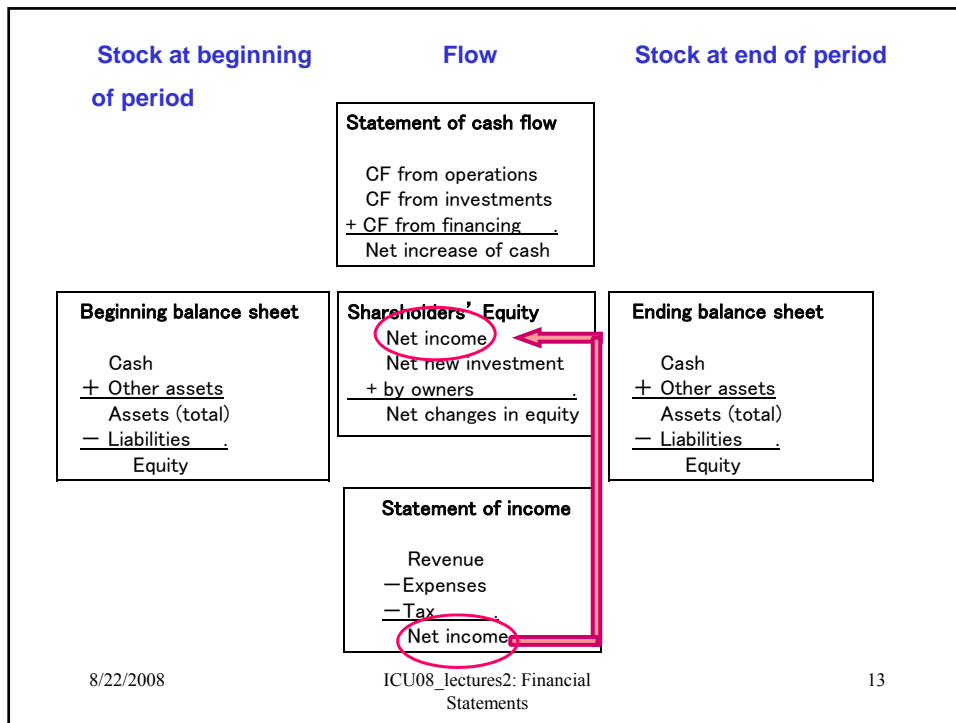
- Cash flows from operating activities
- Cash flows from investment activities
- Cash flows from financing activities

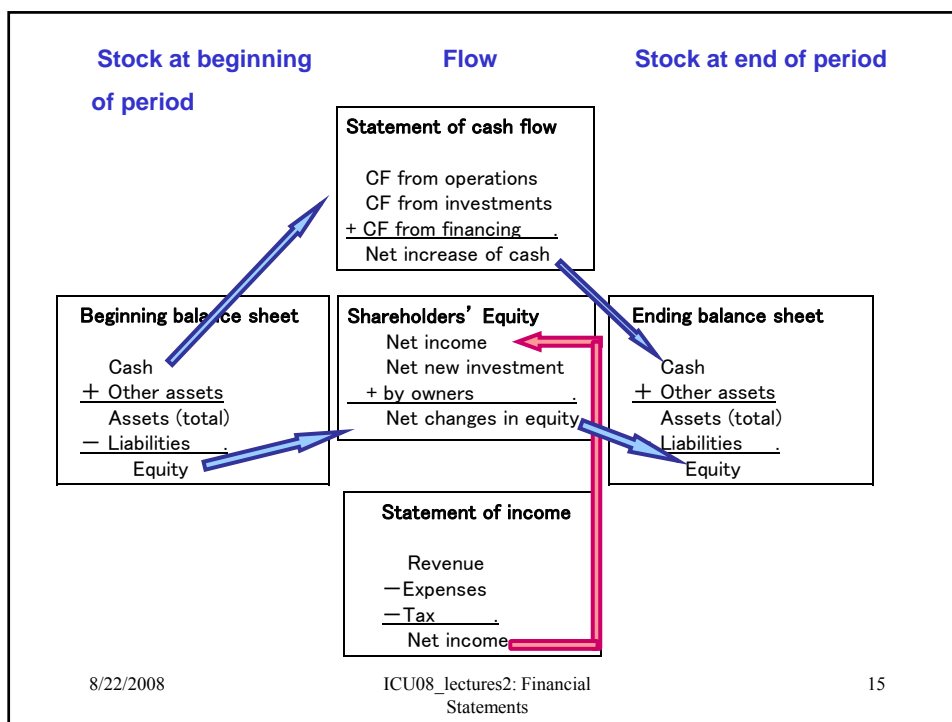
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Market vs accounting valuation

- Shareholders' equity on balance sheet: *book value*
- "No of issued shares" times "stock price"
= *market value*
- Market premium = market value – book value
– "Unrecorded goodwill"?
- Book to market ratio
 - A measure of over pricing
 - Inverse of Tobin's q:
a measure of investment opportunity

Metrics of financial performance

- Operating income margin :
operating profits/net sales
- Net income margin : net income/net sales
- ROA (return on asset) :
net income/total assets
- ROE (return on equity) :
net income/total equity

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- Metrics of leverage
 - Debt-equity ratio
 - Debt-total asset
 - Debt-long-term asset
- Market metrics
 - Price/earnings ratio
 - Book to market ratio
 - Dividend yield

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