Association of Corporate Counsel

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5001 The Top Ten Things You Should Know About Corporate Finance

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Faculty Biography

M. Dana Moore

M. Dana Moore is the managing principal for JEG Consulting Services based out of Chevy Chase, Maryland. The focus of her consulting practice is real estate finance credit services. This includes helping clients to structure their credit and risk evaluation departments, participation as an independent third party on credit committee(s), and providing training on risk analysis.

Prior to founding this company, Ms. Moore worked at Fannie Mae in a variety of credit/risk evaluation functions. Most recently, she was the senior vice president of credit for Fannie Mae's commercial housing lines of business (American Communities Fund, Multi-Family Housing, and CDFIs). Prior to Fannie Mae, Ms. Moore was with Bank of America as senior vice president risk management in the Community Development Bank.

Ms. Moore received a B.A. from Dickinson College and a certificate in accounting from the University of Baltimore. She has completed all course work toward a master's from Johns Hopkins University.

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Why is your understanding of Corporate Finance Important?

- ENRON
- WorldCom
- Arthur Anderson
- Tyco
- Countrywide
- Fannie Mae and Freddie Mac

- Client
  - Firm reputation
  - Ability to do your job
- Investor
  - Protecting your own interest
- Reading the paper
  - It's everywhere

Setting Expectations

- You will not walk away this afternoon ready to start a career as a financial analyst
- You won't walk away ready to join the accounting profession
- You will walk a way with an overview of Corporate Finance and an approach for developing an understanding of any Company

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What is Corporate Finance?

- An area of finance dealing with the financial decisions corporations make and the tools and analysis used to make these decisions (Wikipedia)
- The financial activities of a corporation (Princeton)
- The processed by which companies raise capital especially to fund growth, acquisitions, etc.

What will we cover today?

- For our purposes
  - The basic financial statements and their importance
  - Overview of accountant's role and GAAP
  - Fundamental analytical concepts- liquidity
  - Fundamental analytical concepts - leverage
  - The Corporate Finance Model
  - Capital Markets Overview
  - Corporate reporting and performance pressures
  - Analysis as a contextual exercise
  - Non financial considerations
  - The role of common sense

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Things you need to know

#1 Mind the GAAP

Generally Accepted Accounting Principles

- How and what an accountant measures in a financial statement is different that what a financial analyst measures.
- It is critical to understand certain guiding principles in accounting when evaluating financial statements. Among them:
  - Cost principle
  - Matching principle
  - Revenue Recognition Principle
  - Going Concern
  - Materiality
  - Full disclosure principle
  - Conservatism

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Principles

- Cost: cost refers to the amount spent when an item was originally acquired. Cost is deemed to be the best approximation of value.
- Matching – revenues must be matched with expenses
- Revenue Recognition – revenues are recognized as soon as a product or service is provided
- Going Concern – a company will continue to exist long enough to carry out its objectives and commitments and will not liquidate in the foreseeable future
- Materiality – whether an item is deemed material or not allows the accountant to violate another principle in making decisions
- Full Disclosure – important information to an investor or lender using financial statements should be disclosed within the statement or the footnotes
- Conservatism –where two acceptable alternatives are available for reporting an item, this principle directs the accountant to choose the result that will provide less asset or less revenue

Mind the GAAP
The role of the accountant

- Conflicts arise when you are a paid service provider
- The accountant relies on a great deal of information provided by management
- Issuance of opinion
  - How much work was done?
  - Application of GAAP
  - Going concern issues

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Things You Need to Know

#2 -The Basic Financial Statements

The Basics

- Much of the information that is used in the valuation of a Company and corporate finances comes from financial statements
- The financial statements are comprised of:
  - Balance sheet
  - Income Statement
  - Statement of Cash Flows
  - Footnotes

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Balance Sheet

- A financial statement that provides a picture of the assets, debts, and owner's equity of an entity at a specific time
- Balance Sheet Formula Assets=Liabilities + Owner's Equity

Balance Sheet detail

- Assets - the things in which a company invest so that it can conduct business
- Assets also include monies owed to customers
- Liabilities - monies borrowed to acquire assets
- Owner's equity - what is left over when liabilities are deducted from assets

- Assets
  - Cash
  - Accounts Receivable
  - Inventory
  - Land
  - Equipment
- Liabilities
  - Accounts Payable
  - Accrued expenses
  - Mortgages, bank lines, etc.
- Owner's equity=Assets - Liabilities

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XYZ COMPANY LIMITED
BALANCE SHEET
AS AT
JUNE 30, 2002

UNAUDITED - See "Notice to Reader"

	2002	2001
ASSETS		
CURRENT		
Cash	$ 11,552	$ --
Accounts receivable	42,970	50,595
Deposits and prepaid expenses	2,942	2,688
Inventory	159,144	156,657
	216,608	209,940
PROPERTY, PLANT AND EQUIPMENT (Note 2)	59,890	76,318
INVESTMENTS	--	45,001
	$ 276,498	$ 331,259
LIABILITIES		
CURRENT		
Bank overdraft	$ --	$ 9,474
Bank loan	--	60,000
Accounts payable and accrued liabilities	82,053	91,343
Long-term debt - current portion	25,200	--
Income tax payable	14,387	--
	121,640	160,817
DUE TO SHAREHOLDER (Note 3)	51,591	231,791
LONG-TERM DEBT (Note 4)	86,100	--
	259,331	392,608
SHAREHOLDER'S EQUITY		
STATED CAPITAL (Note 5)	1	1
RETAINED EARNINGS (DEFICIT)	17,166	(61,350)
	17,167	(61,349)
	$ 276,498	$ 331,259

APPROVED

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The accompanying summary of significant accounting policies and notes are an integral part of these financial statements.

Income Statement

- The financial statement which reflects the results of the operations of the company over a specific period of time
- The formula that represents the contents of this statement
- Revenue - expenses = Net Income (or Net Loss)

- Revenue is the income charged for services or products
- Cost of sales are those items directly attributed to producing the products or services sold
- Operating Expenses are those indirect costs that are incurred to support the products sold
- Net income is the profit made for services or products provided after deduction of all expenses

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STATEMENT OF INCOME AND RETAINED EARNINGS
FOR THE YEAR ENDED
JUNE 30, 2002

UNAUDITED - See "Notice to Reader"

	2002	2001
REVENUE	$ 1,104,786	$ 1,133,736
COST OF SALES		
Opening inventory	156,657	146,278
Delivery	1,607	1,249
Purchases	740,994	794,101
	899,258	941,628
Closing inventory	159,144	156,657
	740,114	784,971
GROSS PROFIT	364,672	348,765
OPERATING EXPENSES (schedule)	286,817	339,905
INCOME FROM OPERATIONS	77,855	8,860
OTHER INCOME (EXPENSES)		
Loss on disposal of property, plant and equipment	--	(387)
Gain on sale of investment	16,149	--
Miscellaneous	(1,101)	337
	15,048	(50)
NET INCOME BEFORE TAX	92,903	8,810
INCOME TAX EXPENSE	14,387	--
NET INCOME	78,516	8,810
(DEFICIT) - Beginning of Year	(61,350)	(54,160)
DIVIDENDS	--	(16,000)
RETAINED EARNINGS (DEFICIT) - End of Year	$ 17,166	$ (61,350)

The accompanying summary of significant accounting policies and notes are an integral part of these financial statements.

Statement of Cash Flow

- Financial statement that reconciles the change in the cash position from the beginning of the accounting period to it's end
- This change is a result of the operating, investment and financing activities of the company
- A negative number reflects a use of cash, while a positive number reflects a source of cash

- Typical Presentation
  - Cash flows from operating activities
  - Cash flows from Investing Activities
  - Cash flows from Financing Activities
  - Net Increase or decrease in cash resources

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	[illegible]	[illegible]
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income for the year	$ 78,516	$ 8,810
Adjustment for:		
Amortization	17,854	16,856
Loss on disposal of property, plant and equipment	--	387
Gain on disposal of investment	(16,149)	--
Cash derived from operations	80,221	26,053
Decrease (increase) in working capital items		
Accounts receivable	7,625	23,380
Deposits and prepaid expenses	(254)	688
Inventory	(2,487)	(904)
Accounts payable and accrued liabilities	(9,290)	34,543
Long-term debt - current portion	25,200	--
Income tax payable	14,387	2,206
Cash flows from operating activities	115,402	85,966
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of property, plant and equipment	(1,426)	(10,342)
Proceeds from disposal of property, plant and equipment	--	3,113
Proceeds from disposal of investment	61,150	--
Dividends	--	(16,000)
Cash flows from investing activities	59,724	(23,229)
CASH FLOWS FROM FINANCING ACTIVITIES		
Advances from (repayments to) shareholder	(180,200)	(150,000)
Acquisition of (repayment of) long-term debt	86,100	--
	(94,100)	(150,000)
NET INCREASE (DECREASE) IN CASH RESOURCES	81,026	(87,263)
CASH (DEFICIENCY) RESOURCES - Beginning of Year	(69,474)	17,789
CASH RESOURCES (DEFICIENCY) - End of Year	$ 11,552	$ (69,474)
Cash resources (deficiency) is comprised of:		
Cash	$ 11,552	$ --
Bank overdraft	--	(9,474)
Bank loan	--	(60,000)
	$ 11,552	$ (69,474)

he accompanying summary of significant accounting policies and notes are an integral part of these financial statements.

Footnotes
The Devil is in the Detail

- Some of the most important information in corporate financial reporting is found in the footnotes
- These notes provide a detailed description of the accounting policies, along with the disclosure of other information that can't be shown in the statements themselves
- Footnotes are required as part of the financial statements but there are no standards for clarity. The requirement is to disclose information "beyond the legal minimum" to avoid risk of being sued.

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Footnotes Continued

- Significant accounting policies and practices will be highlighted in the footnotes
- Pension plans and whether they are over or under funded
- Management compensation plans, stock options, will be highlighted
- Contingent liabilities will frequently be disclosed (guarantees, non capitalized leases, off shore or sister companies, etc.)

Things you need to know

#3 Cash is King (Liquidity)

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Solvency and Liquidity

- A company is insolvent when it is unable to meet its financial obligations
- In evaluating solvency, the liquidity of the company, or its ability to quickly generate cash to meet current obligations is evaluated
- The balance sheet reflects the immediate cash, and short term liquid investments
- The footnotes should reflect the availability of lines of credit for short term working capital
- The following ratios provide further insight into the company's ability to raise cash
  - Current ratio
  - Working capital
  - Accounts receivable turnover

Liquidity Calculations and Considerations

- Current Ratio – shows the ability of a Company to meet its current obligations from current assets
  - Current Ratio = Current Assets/Current Liabilities
  - High ratio preferred by short term lenders
- Working Capital -capital within Company to fund cash conversion cycle of company (raw goods to sold goods and accounts receivable to cash)
  - Working capital = current assets – current liabilities
- Accounts receivable turnover (ART) – Number of times the accounts receivable have been collected during the reporting cycle
  - ART = Annual Credit Sales/Accounts Receivable
- Quality
  - Short versus long term asset classifications
  - Collectability of accounts receivable
  - Value of inventory

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Things you need to know

#4 Neither a borrower nor a lender be

Leverage

- The degree debt is used to support operations
- Leverage creates an opportunity for capital invested to gain a higher return
- Risk is greater to capital that balances return with risk of inability to service debt or that asset values change wiping out capital
- In considering the financial risk of debt to the Company:
  - Debt to worth
  - EBITDA coverage ratio
  - Duration match
  - Covenant compliance

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Leverage - detail

- Debt to worth – this shows the extent to which equity cushions debt holders from loss
  - Debt to worth = total liabilities/stockholder equity
- EBITDA coverage ratio – ratio of earnings before interest, taxes, depreciation and amortization to debt payments due
  - The higher the ratio the more cushion current earnings provide to meet the debt service payment
- Duration match – does the borrower funding term match the intended use of funds
- Covenant compliance – frequently buried in the footnotes, the disclosures reflect the terms (financial and non) for the lender from whom money is borrowed

Things you need to know

#5 Finance Model

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Finance Model – Maximizing Corporate Value

- The Investment Decision – Invest in assets that earn a return greater than the minimum acceptable hurdle rate
  - The hurdle rate should reflect the riskiness of the mix of debt and equity used to fund it
  - The return should reflect the magnitude and timing o f the cash flows
- The Financing Decision – Find the right kind of debt for your firm and the right mix of debt and equity
  - The optimal mix of debt and equity maximizes the value of the firm
  - The right kind of debt matches tenor of assets so that platform won't be destabilized
- The Dividend Decision
  - How much cash you choose to return depends on the opportunities you have to deploy your capital
  - Do you choose to dividend the money or buyback stock

Financing Model continued

- There is a cost to everything
  - Equity costs more than debt
  - Weighted cost of capital
  - Return on capital
- Financial decisions within company are driven by cost of capital
- Equity capitalization is part management part market driven

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Things you need to know

#6 Capital Markets

Capital Markets

- The market in which long term debt instruments and equity securities are issued and traded (versus money markets where short term funds are raised Certificates of Deposit, Commercial Paper, etc.)
- The primary market consists of the securities dealers and financial institutions that issue new securities
- The secondary market includes the primary dealers, the Exchanges and the over the counter dealers that buy and sell securities after they are issued

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Capital Markets View

- Given the longer term horizon of funds raised the analytical approach is more that of the risk of ownership
- Standard analytical concepts include:
  - Multiple of book value
  - Market capitalization
  - Earnings Per Share
  - Price Earnings Ratio
  - Dividend Yield Ratio
  - Return on Equity
- Corporate valuation techniques
  - Asset based
  - Earnings
  - Discounted Cash Flow

Definitions

- Market Capitalization – value of company as determined by the market price of its issued and outstanding stock
- Earnings Per Share – portion of company's profit allocated to each outstanding share of common stock
- Price Earnings Ratio –relationship of current price per share to earnings
- Dividend Yield –percentage dividend represents of current stock price
- Return on Equity – amount, expressed as a percentage, earned on a company's stock investment for a given period

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Things you need to know

#7 Under pressure

Operating Environment

- Pressure to make targeted earnings
- P/E ratios
- Dividend targets
- Short term vs. long term results rewarded (quarter to quarter)
- Alignment of management compensation
- Regulatory environment

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Things you need to know

#8 Nature abhors a vacuum

Analytical Vacuum

- To understand a company you can't look at a single set of financial statements
  - Multiple ratios painting the picture
  - Multiple year analysis (spreads)
  - Common size balance sheet
  - Compare to industry
  - Read the research if available
  - Earnings calls

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Things you need to know

#9 Numbers alone don't tell the story

Nonfinancial considerations

- The Company
  - Business Model
  - Competitive Advantage
  - Management
  - Corporate Governance
- Industry condition
  - Market Share
  - Industry Growth
  - Regulation
- Macro economic environment
  - Job growth
  - Interest Rates
  - Consumer Spending

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Things you need to know

#10 When all else fails…common sense applies

Pay attention to your gut

- Accelerating Revenue
- Delaying expenses
- Non-recurring items
- Pension Plans
- Off-balance sheet
- Confusing
- Changing accountants
- Reserves
- Changes in accounting methods
- Special purpose entities and sister companies

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Putting it all together – The top 10 revisited

#1 Understanding who puts the financial statements together, their rules and their bias is critical

#2 The financial statements are the starting point for any understanding of a Company

#3 Understanding cash and the ability to generate cash give us insight into immediate going concern issues

#4 Understanding the pull of debt tell us the demands on the company and its cash and the risk of the capital structure

#5 An overview of how the Company balances its capital structure, its internal needs and the needs of its investors gives context for the management of the Company financials

Pulling it all together – the top 10 revisited

- #6 the demands of the capital markets where long term debt and equity are raised helps sharpen our view of the Company through the perspective of the investment community
- #7 the pressures of being a public company help us understand the management's motivations in making financial decisions
- #8 our understanding requires context from a historical perspective, and an industry perspective
- #9 numbers are only part of the story there is much more to understand and not to overlook
- #10 Your tummy can tell you a great deal in developing your understanding of any Company

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