Association of Corporate Counsel

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104 Finance & Accounting for In-house Counsel

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Faculty Biographies

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.

What will we cover today?

- Ten accounting and finance issues:
  - Overview of accountant's role and GAAP
  - The basic financial statements and their importance
  - 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

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 than 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

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

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

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

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

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

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.

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)

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
  - Ability to collect accounts receivable
  - Value of inventory

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

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

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 processes by which companies raise capital especially to fund growth, acquisitions, etc.

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

Things you need to know

#6 Capital Markets

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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

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

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

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

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

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

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 pressure of being a public company help us understand 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

Important Links in support of understanding Financial Statements, and Corporate Finance

1. Accounting Terminology Guide: http://www.nysscpa.org/prof_library/guide.htm

This website provides a basic glossary of accounting terms. The site was established for journalists who report and interpret financial information. It is a handy reference guide which can be printed out for future reference. Please note in the address above between the words prof and library there is a "_" which is obscured by the line. If you cut and paste the address you will be fine, if you enter by hand please remember the underscore.

2. Glossary of Financial Terms: http://library.thinkquest.org/3096/9gloss.htm

This website provides a glossary of terms for investing analysis, and is also a handy reference guide.

3. Financial Ratios: http://www.netmba.com/finance/financial/ratios/

For those who are braver, and might want to have the formulas behind the ratios, this website will walk you through definitions, the strengths and weaknesses of each ratio, and the calculation.

4. Introduction to Accounting Principles: http://www.accountingcoach.com/online-accounting-course/09Xpg01.html

This article provides an introduction to Accounting Principles and the general rules and concepts that govern the field of accounting.

5. A Primer on Financial Statements: http://pages.stern.nyu.edu/~adamodat/New Home Page/AccPrimer/accstate.htm

This is an article that discusses the information used in valuation and corporate finance – the financial statements. It indicates what questions need to be asked and provides a context for answering them.

A non specific link but a site I would recommend, for its clear articles answering a host of finance, accounting, and other related questions is…Investopedia.com