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INTRODUCTION TO CORPORATE FINANCE

Lesson 1&2

Corporate Finance

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SUMMARY

- Introduction to Corporate Finance
- Introduction to Financial Statement
- Balance Sheet and Income Statement reclassification

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Corporate Finance: The Subject

- Corporate Finance is the area of finance dealing with the sources/uses of funding and the capital structure of corporations and the actions that managers take to increase the value to the shareholders.
- Therefore, both **financing strategies** and **investing strategies** are concerned.

Corporate Finance: Decisional fields

- Corporate finance decisions can be divided into three main different areas which are, anyway, strictly linked each other.
  - **Investing** decisions (how to use resources)
  - **Financing** decisions (how to raise resources)
  - **Ordinary business administration** decisions (this refers to the dynamics of financial flows and the management of working capital)

A CORRECT CORPORATE FINANCE ACTIVITY

- A complete and structured **planning activity** is the preliminary condition for a correct process of financial resources management within the company's structure.
- This planning activity has the aim of keeping safe the financial situation both in the short and in the long term. Moreover, it allows the company's managers to coordinate the decisions related to the three previously mentioned decisional fields.

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THE ANALYSIS: TOOLS

- The analysis of a financial statement can be performed through the use of different tools, such as the following.
  - Financial ratios
  - Budgeting (projections)
  - Flow analysis
- The latter, in particular, is the most widely used in cash flow analysis. The flow analysis is the most suitable method to assess the financial dynamics of a company because it focuses on flows and not on static items.

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FINANCIAL STATEMENT ANALYSIS vs. CASH FLOW ANALYSIS

Financial statement analysis	vs.	Cash flow analysis
Leading principle: **Accrual Basis (Period)**		**Leading principle:** **Cash**

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THE FINANCIAL STATEMENT ANALYSIS

- The financial statement analysis deals with examinations which go beyond the simple calculation of the net profit and the valuation of corporate assets. It is possible to identify:
  - **Profit and Loss** analysis;
  - **Balance Sheet (asset and liabilities)** analysis;
  - **Cash flow** analysis, which highlights the ability of a business to face its financial needs and obligations.
- Therefore, cash flow analysis is a part of the more comprehensive process called ''financial statement analysis''.

CASH FLOW ANALYSIS: A DYNAMIC ANALYSIS

- The **financial statement analysis**, through the analysis of profit & loss, asset & liabilities or ratios, focuses on the financial structure of a company at any given time (in particular the financial statement reference date) and shows how the situation changes from one financial year to the other.
- On the other hand, cash flows analysis clarifies the reasons why certain variations have occurred. Being this kind of analysis focused on the variations occurred through the financial year, it is defined as dynamic.

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INTRODUCTION TO FINANCIAL STATEMENT

Static Analysis → *Dynamic Analysis*

Ratios → **Flows**

- ✓ Flows from operations
- ✓ Flows from investments and financing

INTRODUCTION TO FINANCIAL STATEMENT

Static Analysis ⇒ *Assets = Liabilities + Equity*

↓

Dynamic Analysis ⇒ *Uses of cash = Sources of cash*

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FINANCIAL STATEMENT: CHARACTERISTICS

- The objective of a financial statement is to provide an information that is useful in making economic decisions.
- The **comparability** of the information of the company's financial statements of previous years is really important.
- The income statement and the balance sheet are prepared under the **accrual basis** of accountings.

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INCOME STATEMENT

- The objective of every business is to increase the company's value.
- The Profit and Loss (Income Statement) reports all the revenues of the business and all the costs of a given period (financial year) and leads to the earnings of that period, that is the net addiction/deduction to the company's wealth.
- It reports both **operating** and **non-operating** activities.

↓

Direct result of the core business of the company

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INCOME STATEMENT: OPERATING CYCLE

- A company's **operating cycle** forms the basis of its wealth.
- Operating revenues – operating costs = **Earning before interest, tax, depreciation and amortization** (EBITDA), which is an important measure of company's profitability.

+ Change in inventories
- Cost of goods sold
- General & administrative costs
- Personnel expenses
- Services
…….

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INCOME STATEMENT: INVESTMENT CYCLE

- Investing activities do not appear directly on the income statement.
- But accrual accountings require that an asset's cost has to be proportionally expensed based on the period of time over which the asset is used.
- The Income Statement reports the allocation of fixed assets' cost over their useful life (depreciation and amortization).
- **Depreciation** (tangible assets) and **amortization** (intangible assets) are "**non-cash items**" .

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INCOME STATEMENT: INVESTMENT CYCLE

Earning before interest, tax, depreciation and amortization (**EBITDA**)
- Depreciation and Amortization
= Earnings before Interest and Taxes (**EBIT**)

- EBIT represents the earning generated by the investment and operating cycles.

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Income Statement: financial cycle

- The Income Statement shows only the charges (e.g. interest) related to borrowings.
- It doesn’t show the repayments of borrowings that are deducted from the debt recorded on the balance sheet.
- Moreover, the financial cycle considers also financial incomes (e.g. capital gains).
- Financial income – financial charges = **Net financial income**.

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INCOME STATEMENT: EXTRAORDINARY ITEMS

- The Income statement reports gains or losses related to unforeseen and atypical events.
- They are accounted separately because they are not expected to recur frequently or regularly and they are beyond the control of a company's management.

Earnings before Interest and Taxes (**EBIT**)

\- Net Financial Income

\- Extraordinary items

= Earning before taxes (**EBT**)

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THE INCOME STATEMENT (PROFIT AND LOSS)

Sales

- Operating expenses

= EBITDA

- Depreciation and Amortization

= EBIT

- Net Financial Income

- Extraordinary items

= EBT

- Taxes

= Net Result

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BALANCE SHEET

- The purpose of a balance sheet is to list all the assets of a business and all of its financial resources at a given time.

- **Assets** on a balance sheet comprise the following.
  - Fixed assets: tangible, intangible and financial assets
  - Current assets as part of the operating cycle such as inventories and trade receivables
  - Cash and cash equivalents

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Balance Sheet

- Resources on a balance sheet comprise the following.
  - Capital provided by shareholders, plus retained earnings, known as **shareholders' equity**
  - Borrowings of any kind that the business may have arranged , know as **liabilities**
- **Company's assets and resources must be equal!**

FIXED ASSETS	SHAREHOLDERS' EQUITY
CURRENT ASSETS	LIABILITIES

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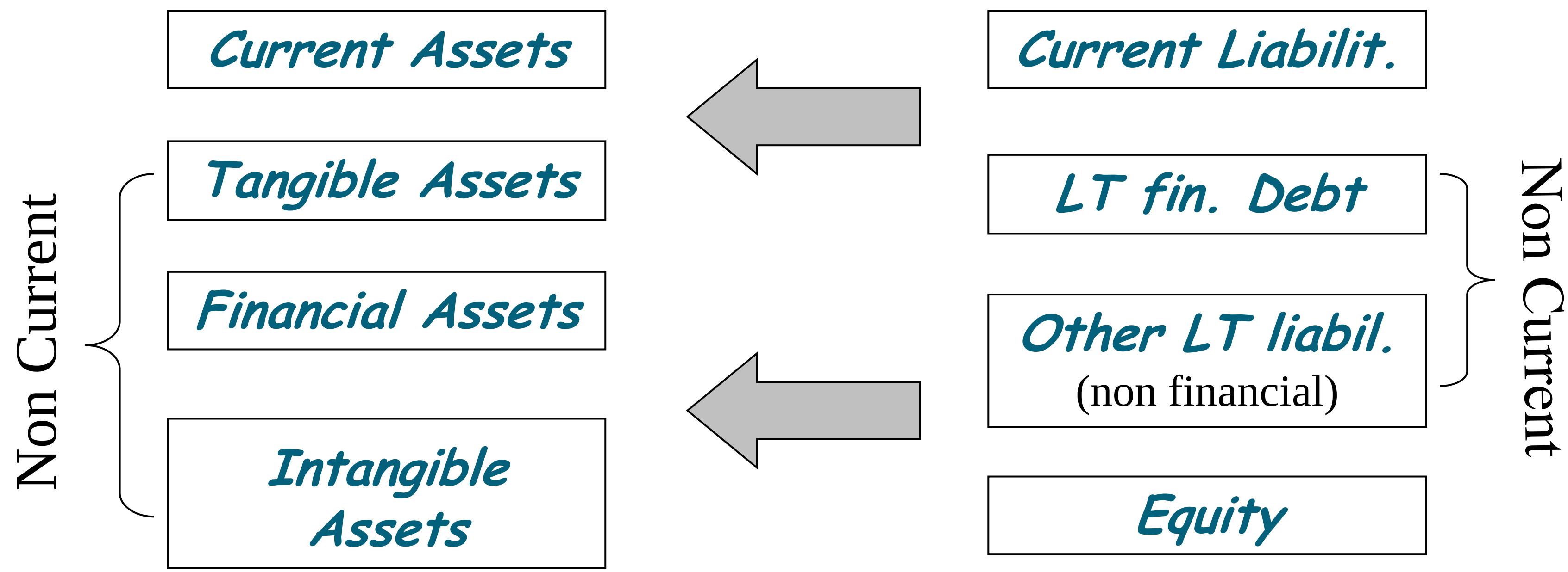
BALANCE SHEET



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BALANCE SHEET: RECLASSIFICATION

Current Assets

Cash and Cash Equivalents

Deferred liquidity (commercial receivables [- bad debts provision], other current receivables, accruals & prepayments)

Inventories (raw materials, semi-processed, finished goods)

Fixed Assets

Tangible Assets [- depreciation]

Intangible Assets [- amortization]

Financial Assets

Financial Items - over 12 months

Current Liabilities

Short Term financial debt (bank overdrafts)

Other Current Liabilities (commercial payables, tax payables, other payables, accrued expenses)

Non-current Liabilities

ETP fund, risk funds, other long term non-financials liabilities

Bonds, bank loans, other long term financial debts

Shareholders Equity

Share Capital

Reserves

Net Result of the Year

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Net Financial Position

Medium – long term bank and other borrowings (bond issues, commitment under finance lease…)

+ Short-term bank or financial borrowings (discounted notes, bank overdrafts ….)

- Marketable securities

- Cash and cash equivalents

= **Net financial position**

- Net financial position can be either positive or negative.
- If it is negative, the company is said to have <u>net cash</u>.