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Understanding Financial Statements II

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Tonight's Agenda

- Debriefing of the Case: Identifying Industries
- Income Statement Metrics
- Balance Sheet Metrics

Identify Industries

Identify Industries

The Four Financial Statements

1. Balance Sheet
2. Income Statement
3. Cash Flow Statement
4. Statement of Shareholders' Equity

Form and Content in Financial Statements

- Form is the way in which the statements and their components parts fit together.
- Content is the measurement of the line items that are reported within the component parts of financial statements.
- The form gives the overall story that the statements are telling.
- The content puts numbers into the story.

Balance Sheet: Walmart Inc

| ASSETS (In Millions) | Jan. 31, 2015 | Jan. 31, 2014 |
|-------------------------------------------|---------------|---------------|
| Current assets: | | |
| Cash and cash equivalents | \$9,135 | \$7,281 |
| Receivables, net | 6,778 | 6,677 |
| Inventories | 45,141 | 44,858 |
| Prepaid expenses and other | 2,224 | 1,909 |
| Current assets of discontinued operations | 0 | 460 |
| Total current assets | 63,278 | 61,185 |
| Property and equipment: | | |
| Property and equipment | 182,634 | 178,678 |
| Less accumulated depreciation | -65,979 | -60,771 |
| Property and equipment, net | 116,655 | 117,907 |
| Goodwill | 18,102 | 19,510 |
| Other assets and deferred charges | 5,671 | 6,149 |
| Total assets | 203,706 | 204,751 |

Balance Sheet: Walmart Inc.

| Liabilities and Equity (In Millions) | Jan. 31, 2015 | Jan. 31, 2014 |
|---------------------------------------------------------------|---------------|---------------|
| Current liabilities: | | |
| Short-term borrowings | 1,592 | 7,670 |
| Accounts payable | 38,410 | 37,415 |
| Accrued liabilities | 19,152 | 18,793 |
| Accrued income taxes | 1,021 | 966 |
| Long-term debt due within one year | 5,097 | 4,412 |
| Current liabilities of discontinued operations | 0 | 89 |
| Total current liabilities | 65,272 | 69,345 |
| Long-term debt | 43,692 | 44,559 |
| Deferred income taxes and other | 8,805 | 8,017 |
| Redeemable noncontrolling interest | 0 | 1,491 |
| Equity | | |
| Total Walmart shareholders' equity | 81,394 | 76,255 |
| Nonredeemable noncontrolling interest | 4,543 | 5,084 |
| Total equity | 85,937 | 81,339 |
| Total liabilities, noncontrolling interest, and equity | \$203,706 | \$204,751 |

The Form of the Balance Sheet

Assets = Liabilities + Shareholders' Equity
or

Shareholders' Equity = Assets - Liabilities

Compare to:

Value of Equity = Value of Firm - Value of Debt

Income Statement: Walmart, Inc.

| In millions. | Fiscal year ended | |
|----------------------------------------------------------------------|-------------------|-----------------|
| | Jan.31,2015 | Jan.31, 2014 |
| Revenues: | | |
| Net sales | 482,229 | 473,076 |
| Membership and other income | 3,422 | 3,218 |
| Total revenues | 485,651 | 476,294 |
| Cost of sales | 365,086 | 358,069 |
| Operating, selling, general and administrative expenses | 93,418 | 91,353 |
| Operating income | 27,147 | 26,872 |
| Interest: | | |
| Debt | 2,161 | 2,072 |
| Capital leases | 300 | 263 |
| Interest income | -113 | -119 |
| Interest expense, net | 2,348 | 2,216 |
| Income from continuing operations before income taxes | 24,799 | 24,656 |
| Provision for income taxes: | 7,985 | 8,105 |
| Income from continuing operations | 16,814 | 16,551 |
| Income from discontinued operations, net of income taxes | 285 | 144 |
| Consolidated net income | 17,099 | 16,695 |
| Less consolidated net income attributable to noncontrolling interest | -736 | -673 |
| Consolidated net income attributable to Walmart | \$16,363 | \$16,022 |

The Form of the Income Statement

Net Revenue - Cost of Goods Sold = Gross Margin

Gross Margin - Operating Expenses = Earnings before Interest and Tax
(EBIT)

EBIT + Interest Income - Income Expense = Income before Taxes

Income before Taxes - Income Taxes = Income after Taxes
(and before extraordinary Items)

Income before Extraordinary Items + Extraordinary Items (Net of tax)
= Net Income

Earnings per share (EPS) = Net Income / Total Shares Outstanding

SWS #6 Understanding Financial Statements II by Prof. Liang



Cash Flow Statement: Walmart Inc.

| In Millions, unless otherwise specified | Fiscal year ended | |
|----------------------------------------------------------|-------------------|---------------|
| | Jan. 31, 2015 | Jan. 31, 2014 |
| Cash flows from operating activities: | | |
| Consolidated net income | \$17,099 | \$16,695 |
| Income from discontinued operations, net of income taxes | -285 | -144 |
| Income from continuing operations | 16,814 | 16,551 |
| Adjustments: | | |
| Depreciation and amortization | 9,173 | 8,870 |
| Deferred income taxes | -503 | -279 |
| Other operating activities | 785 | 938 |
| Changes in certain assets and liabilities | | |
| Receivables, net | -569 | -566 |
| Inventories | -1,229 | -1,667 |
| Accounts payable | 2,678 | 531 |
| Accrued liabilities | 1,249 | 103 |
| Accrued income taxes | 166 | -1,224 |
| Net cash provided by operating activities | 28,564 | 23,257 |

Jan. 31, 2015 Jan. 31, 2014

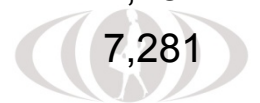
Cash flows from investing activities:

| | | |
|------------------------------------------------------|----------------|----------------|
| Payments for property and equipment | -12,174 | -13,115 |
| Proceeds from the disposal of property and equipment | 570 | 727 |
| Proceeds from the disposal of certain operations | 671 | 0 |
| Other investing activities | -192 | -138 |
| Net cash used in investing activities | -11,125 | -12,526 |

Cash flows from financing activities:

| | | |
|----------------------------------------------|----------------|----------------|
| Net change in short-term borrowings | -6,288 | 911 |
| Proceeds | 5,174 | 7,072 |
| Payments of long-term debt | -3,904 | -4,968 |
| Dividends paid | -6,185 | -6,139 |
| Purchase of Company stock | -1,015 | -6,683 |
| Dividends paid to noncontrolling interest | -600 | -426 |
| Purchase of noncontrolling interest | -1,844 | -296 |
| Other financing activities | -409 | -260 |
| Net cash used in financing activities | -15,071 | -10,789 |

| | | |
|-------------------------------------------------------|-------|-------|
| Effect of exchange rates on cash and cash equivalents | -514 | -442 |
| Net increase (decrease) in cash and cash equivalents | 1,854 | -500 |
| Cash and cash equivalents at beginning of year | 7,281 | 7,781 |
| Cash and cash equivalents at end of year | 9,135 | 7,281 |



The Form of the Cash Flow Statement

$$\begin{aligned} \text{Change in Cash} = & \text{Cash flows from Operations} \\ & + \text{Cash flows from Investing} \\ & + \text{Cash flows from Financing} \end{aligned}$$

Free Cash Flow = Cash Flows from Operations – Cash flows from investing (with some adjustments for interest and financial investments)

The Stocks and Flow Equation

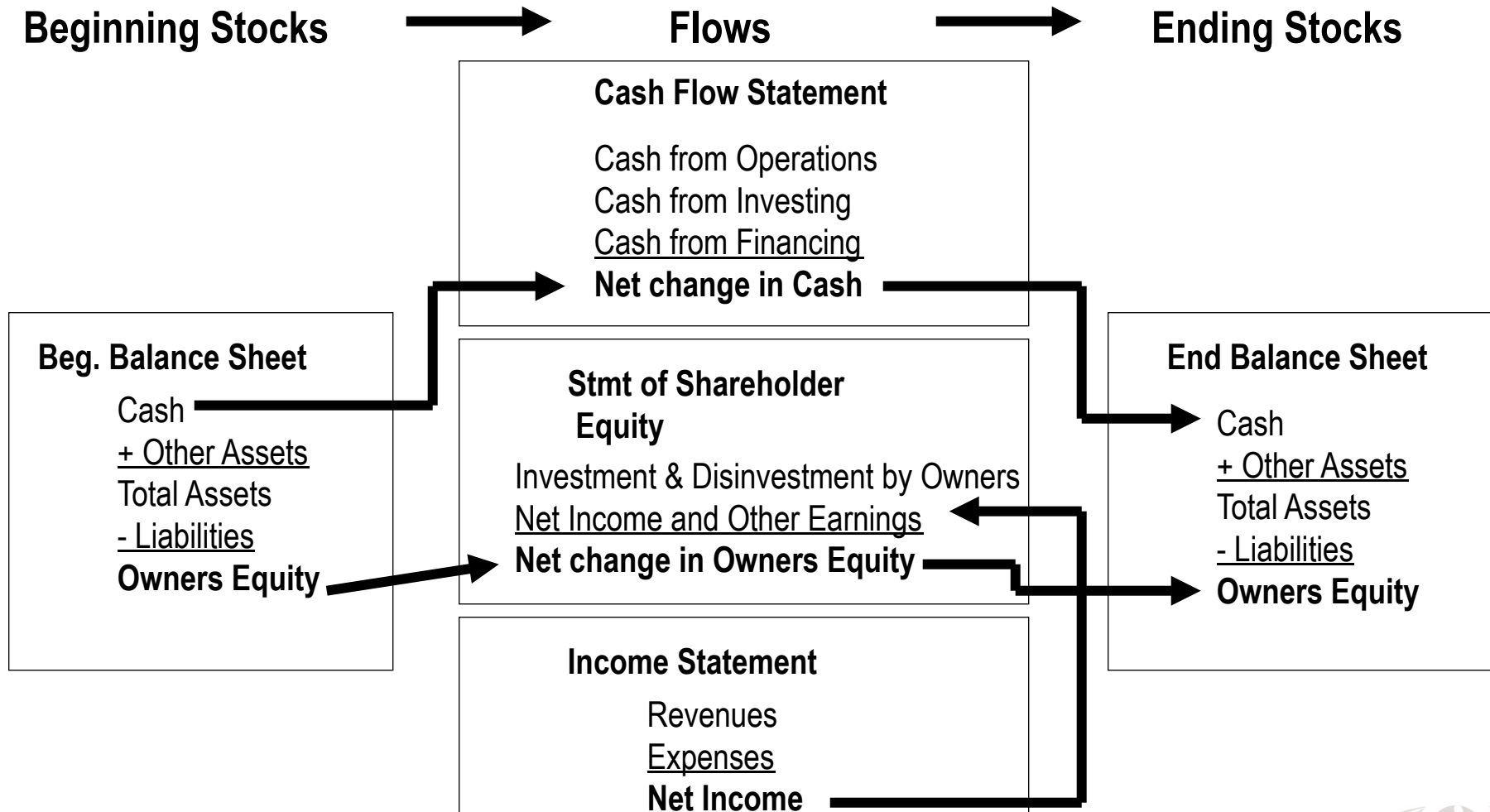
Law of Motion for Equity

- Ending equity =
Beginning equity
+ Comprehensive income
– Net payout to shareholders (e.g., dividends)

Accounting value added:

- Comprehensive income

Articulation of Financial Statements



Common Size Analysis of Balance Sheet and Income Statement

Common size analysis gives a ready comparison:

- The Income Statement
 - Each item/Total revenues
- The Balance Sheet
 - Operating items/Total operating assets (liabilities)
 - Financing items/Total financial assets (liabilities)
- Comparison may be time-series or cross-sectional

Common size analysis

- **Common size analysis allows us to answer:**
 - What is a firm's revenue and expenses structure?
 - What is the operating profitability per dollar of sales?
 - How does other activities (including financing) impact the net profit?
 - How does financing activities impact the net profit?
 - What are the assets and liabilities compositions?
 - What is the firm's financing strategy as reflected in financing assets and liabilities compositions?
- **Companies in the same industries should have more similar structures than in different industries**

Common Size Analysis: Income Statement, Walmart

| | Jan. 31, 2015 | Jan.31, 2014 |
|----------------------------------------------------------------------|---------------|--------------|
| Total revenues | 100.00% | 100.00% |
| Cost of sales | 75.17% | 75.18% |
| Operating, selling, general and administrative expenses | 19.24% | 19.18% |
| Operating income before tax | 5.59% | 5.64% |
| Interest expense, net | 0.48% | 0.47% |
| Income from continuing operations before income taxes | 5.11% | 5.18% |
| Provision for income taxes: | 1.64% | 1.70% |
| Income from continuing operations | 3.46% | 3.47% |
| Income from discontinued operations, net of income taxes | 0.06% | 0.03% |
| Consolidated net income | 3.52% | 3.51% |
| Less consolidated net income attributable to noncontrolling interest | -0.15% | -0.14% |
| Consolidated net income attributable to Walmart | 3.37% | 3.36% |

Income statement: Amazon

Consolidated Statements Of Operations (USD \$)

12 Months Ended

In Millions, except Per Share data, unless otherwise specified

| | Dec. 31, 2014 | Dec. 31, 2013 | Dec. 31, 2012 |
|-----------------------------------------------|----------------|---------------|---------------|
| Net product sales | \$70,080 | \$60,903 | \$51,733 |
| Net service sales | 18,908 | 13,549 | 9,360 |
| Total net sales | 88,988 | 74,452 | 61,093 |
| Operating expenses: | | | |
| Cost of sales | 62,752 | 54,181 | 45,971 |
| Fulfillment | 10,766 | 8,585 | 6,419 |
| Marketing | 4,332 | 3,133 | 2,408 |
| Technology and content | 9,275 | 6,565 | 4,564 |
| General and administrative | 1,552 | 1,129 | 896 |
| Other operating expense (income), net | 133 | 114 | 159 |
| Total operating expenses | 88,810 | 73,707 | 60,417 |
| Income from operations | 178 | 745 | 676 |
| Interest income | 39 | 38 | 40 |
| Interest expense | -210 | -141 | -92 |
| Other income (expense), net | -118 | -136 | -80 |
| Total non-operating income (expense) | -289 | -239 | -132 |
| Income (loss) before income taxes | -111 | 506 | 544 |
| Provision for income taxes | -167 | -161 | -428 |
| Equity-method investment activity, net of tax | 37 | -71 | -155 |
| Net income (loss) | (\$241) | \$274 | (\$39) |

Common-size Income Statement: Amazon

| | Dec. 31, 2014 | Dec. 31, 2013 |
|--------------------------------------------------|---------------|---------------|
| Total net sales | 100.0% | 100.0% |
| Operating expenses: | | |
| Cost of sales | 70.5% | 72.8% |
| Fulfillment | 12.1% | 11.5% |
| Marketing | 4.9% | 4.2% |
| Technology and content | 10.4% | 8.8% |
| General and administrative | 1.7% | 1.5% |
| Other operating expense (income), net | 0.1% | 0.2% |
| Total operating expenses | 99.8% | 99.0% |
| Income from operations | 0.2% | 1.0% |
| Interest income | 0.0% | 0.1% |
| Interest expense | -0.2% | -0.2% |
| Other income (expense), net | -0.1% | -0.2% |
| Total non-operating income (expense) | -0.3% | -0.3% |
| Income (loss) before income taxes | -0.1% | 0.7% |
| Provision for income taxes | -0.2% | -0.2% |
| Equity-method investment activity, net of tax | 0.0% | -0.1% |
| Net income (loss) | -0.3% | 0.4% |

Common-size Balance Sheet: Walmart Inc

| ASSETS (In Millions) | Jan. 31, 2015 | Jan. 31, 2014 |
|-------------------------------------------|----------------|----------------|
| Current assets: | | |
| Cash and cash equivalents | 4.48% | 3.56% |
| Receivables, net | 3.33% | 3.26% |
| Inventories | 22.16% | 21.91% |
| Prepaid expenses and other | 1.09% | 0.93% |
| Current assets of discontinued operations | 0.00% | 0.22% |
| Total current assets | 31.06% | 29.88% |
| Property and equipment, net | 57.27% | 57.59% |
| Goodwill | 8.89% | 9.53% |
| Other assets and deferred charges | 2.78% | 3.00% |
| Total assets | 100.00% | 100.00% |

| Liabilities and Equity (In Millions) | Jan. 31, 2015 | Jan. 31, 2014 |
|---------------------------------------------------------------|----------------------|----------------------|
| Current liabilities: | | |
| Short-term borrowings | 0.78% | 3.75% |
| Accounts payable | 18.86% | 18.27% |
| Accrued liabilities | 9.40% | 9.18% |
| Accrued income taxes | 0.50% | 0.47% |
| Long-term debt due within one year | 2.50% | 2.15% |
| Current liabilities of discontinued operations | 0.00% | 0.04% |
| Total current liabilities | 32.04% | 33.87% |
| Long-term debt | 21.45% | 21.76% |
| Deferred income taxes and other | 4.32% | 3.92% |
| Redeemable noncontrolling interest | 0.00% | 0.73% |
| Equity | | |
| Total Walmart shareholders' equity | 39.96% | 37.24% |
| Nonredeemable noncontrolling interest | 2.23% | 2.48% |
| Total equity | 42.19% | 39.73% |
| Total liabilities, noncontrolling interest, and equity | 100.00% | 100.00% |

Why Perform Financial Statement Analysis?

Historical, present and future ratios are useful in:
Evaluation and Valuation

What **performance indicators** you would like to have as an owner?

- How fast are the revenues growing? (**Growth**)
- What is the operating margin? (**Profitability**)
- What is the efficiency of asset usage? (**Turnover**)
- Optimal mixture of debt and equity financing? (**Leverage**)

Some basic ratios

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average (or Beginning) Stockholders' Equity}}$$

$$\text{Return on Assets} = \frac{\text{Net Income} + \text{Interest Expense (net of tax)}}{\text{Average (or Beginning) Total Assets}}$$

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Stockholders' Equity}}$$

Walmart and Amazon: simple ratios

| | 2014 | 2013 |
|----------------------|-------------|-------------|
| Walmart | | |
| Return on equity | 20.76% | 21.00% |
| Return on Assets | 9.15% | 8.92% |
| Profit margin | 3.55% | 3.53% |
| Debt-to-equity ratio | 1.37 | 1.52 |
| Amazon | | |
| Return on equity | -2.35% | 3.05% |
| Return on Assets | -0.51% | 0.75% |
| Profit margin | -0.27% | 0.37% |
| Debt-to-equity ratio | 4.07 | 3.12 |

Summary

- Key elements of four financial statements
- Understand the principles and the articulation of different statements
- Accounting measurements of value and value added
- Common-size analysis and some basic ratios