
MSA 643

Sport Finance

Belhaven University

Unit 5

Financial Statements, Forecasts, Planning,
and Spending Earnings

Introduction

- This unit will discuss the nuts and bolts of financial statements, and show how cash flow is derived from these basic financial documents
 - Additionally, the steps involved in financial forecasting and planning will be introduced.
 - It will also describe the basic accounting statements that businesses use for reporting purposes.
 - Lastly, the unit will conclude discussing retained earnings, dividends, and legal concerns with mergers and acquisitions.
-

Topics

- Types of Financial Statements
 - Types of Financial Ratios
 - Spending Earnings
-

Objectives

- Identify the elements of the balance sheet.
- Identify the elements of the income statement.
- Discuss the cash flow statement and relate it to the income statement and the balance sheet.
- Define common financial ratios used to assess an organization's liquidity, activity, financial leverage, profitability, and inventory as well as the firm's collection cycle.
- Describe various types of dividend policies and how they are used.
- Describe various types of dividend policies and how they are used.
- Outline the dividend payment process.
- Describe how a business utilizes retained earnings.
- Understand how mergers and acquisitions are a way for a sport business to expand.
- Describe the legal concerns associated with mergers and acquisitions.
- Calculate the value of a consolidated business after a merger.

Financial Statements, Forecasts, and Planning

Current Versus Fixed Assets

Current Assets (Most Liquid)

- Assets that can be converted to cash in one year or less
 - Examples
 - cash
 - short-term financial assets
 - accounts receivable (money not yet collected from customers for goods sold to them)
 - inventory (raw materials used in manufacturing, in work in progress, or in finishing goods)
 - deferred income taxes and prepaid expenses
-

Current Versus Fixed Assets, cont.

Fixed Assets (Least Liquid)

- Assets on the balance sheet with the least liquidity
 - Examples
 - real estate
 - plant
 - equipment
-

Current Versus Long-Term Liabilities

Current Liabilities

- Must be paid in one year or less
 - Accounts payable (bills to vendors, not yet paid)
 - Compensation due to players, coaches, and management in one year or less
 - Interest and principal on long-term debt
 - Accrued liabilities (expenses recorded when they are incurred but before they are paid)
-

Current Versus Long-Term Liabilities, cont.

Long-Term Liabilities

- Will not be paid down completely for more than one year
 - Players' compensation (e.g., five-year contract)
 - Shareholders' equity (value of the stockholders' investment in the company)
 - Deferred income taxes
-

Net Working Capital

Also called simply *working capital*.

- Net working capital equals current assets minus current liabilities.
- When this number is positive, the firm expects the cash paid out over the next year to be less than the cash that will become available.
- An investment in working capital is an increase in net working capital between two points in time on a balance sheet.

Income Statement

The income statement describes how much profit or loss was earned by a business over a given length of time.

- Income equals revenue minus expenses.
 - An income statement has three parts:
 1. Revenues and expenses from the company's operations
 2. A non-operating section including financing costs and any income earned by financial investments (also, all taxes)
 3. Net income of the business
-

Statement of Cash Flow

The statement of cash flow provides information about how the cash position of a business has changed over a given period of time.

- It measures cash flowing into and out of the business.
 - There are three primary sources:
 1. Cash flows from (used in) operating activities
 2. Cash flows from (used in) investing activities
 3. Cash flows from (used in) financing activities
-

Types of Financial Ratios

- Liquidity
 - Activity
 - Financial leverage
 - Profitability
 - Value of the firm
-

Liquidity Ratios

Liquidity ratios measure the ability of a business to meet short-term financial obligations.

Current ratio

- Measures if the sale of current assets will cover liabilities
- Above 1 (can sell assets to cover liabilities)
- Below 1 (cannot cover liabilities with sale)

Acid test ratio

- Also known as the quick ratio
 - Examines whether a firm can pay its current liabilities without relying on the sale of inventories
-

Activity Ratios

Activity ratios measure how effectively a firm manages its assets.

- Total asset turnover ratio: How effectively the firm uses its assets to generate sales.
 - Inventory turnover ratio: How many times during the year the inventory is purchased and sold.
 - Receivables turnover ratio
 - Average collection period
-

Financial Leverage Ratios

Financial leverage ratios measure the extent to which a business relies on debts (loans) rather than equity (stocks) for financing. High ratios equal greater chance for distress and bankruptcy.

- Debt ratio: Analyzes a business' leverage from the standpoint of assets.
 - Debt–equity ratio: Analyzes a business' leverage from the standpoint of owners' equity.
 - Interest coverage ratio
-

Profitability Ratios

Profitability ratios measure the extent to which a business is profitable.

Return on assets (ROA)

- Also known as return on investment
- Reflects amount of profits earned on the investment in all assets of the firm
- Measures profitability on investment by *all* providers of funds
- $ROA = \text{net income} / \text{average total assets}$

Return on equity (ROE)

- Measures profitability on investment by stockholders
 - $ROE = \text{net income} / \text{average stockholders' equity}$
-

Profitability Ratios, cont.

Bottom line for companies is their ability to generate sufficient earnings to continue growth and reward shareholders

- **Net profit margin:** Net income divided by revenues.
 - **Gross profit margin:** Gross income divided by revenues.
 - **Return on investment capital (ROIV):** Analyzes performance via long-term investments that fund growth.
-

Techniques to Determine an Investment's Value

- **Annual return per share:** increase or decrease in value + dividends
- **Annual rate of return:** annual return / initial investment
- **Dividend payout ratio:** dividends per share / earnings per share
- **Earnings per share:** net income / average number of shares outstanding
- **Price–earnings ratio (PE ratio):** price per share / earnings per share

Spending Earnings

Earnings

- For-profit organizations can use positive earnings in three ways:
 1. Pay dividends to shareholders.
 2. Retain earnings for reinvestment in the business.
 3. Reinvest in other firms by purchasing a percentage or acquiring other firms outright.
 - The key to financial success is selecting the option that will produce the greatest value to the firm.
-

Dividends

- Dividends: Payments to shareholders made out of earnings, in the form of either cash or stock.
 - *Example:* Speedway Motorsports made a quarterly dividend payment of \$0.10 per share in 2011.
 - There are two types of dividend payments:
 1. Cash dividend
 2. Stock dividend
-

Reinvestment

- **Reinvestment:** Retention of earnings to reinvest in the business for it to grow and thrive.
 - Forgoing dividend payments to reinvest the earnings in the business must be approved by the board of directors.
 - The level of retained earnings is closely tied to the capital structure of the organization.
-

Mergers and Acquisitions

- These are another way a business can use its earnings.
 - Goal is to increase shareholder wealth.
- In 2010 more than \$822 billion in mergers occurred in the United States.

Justifications for a Merger

- Perhaps the best justification is economies of scale, the idea that “bigger is better” and more efficient.
 - Cost savings are not related to economies of scale.
 - Merger leads to new revenue sources.
 - *Example:* IMG and ISP Sports Marketing merger
 - One party involved in merger is poorly managed.
-

Types of Mergers

■ Horizontal Mergers

- Two companies in the same line of business are joined together.

- *Examples:* Nike and Converse; Adidas-Salomon and Reebok

■ Vertical Mergers

- Buyer expands operations forward toward the final consumer or backward in the direction of the source of the raw materials.

- *Example:* Breeze and Max Snowboards

■ Conglomerate Mergers

- Companies in unrelated lines of business come together.

- *Example:* Rossignol and Quicksilver

Mergers and Antitrust Law

- Three primary statutes govern mergers:
 1. Sherman Antitrust Act of 1890
 2. Federal Trade Commission Act of 1914
 3. Clayton Act of 1914
 - Overall, they forbid mergers that constrain trade, greatly lessen market competition, or potentially constrain trade or competition.
 - In the United States, the laws are enforced by the Federal Trade Commission and the U.S. Department of Justice.
-

Forms of Acquisition

- There are three methods for legally acquiring another business:
 1. Merging two companies
 2. Purchasing voting stock
 3. Purchasing assets
-

Merging of Two Companies

■ **Advantages:**

- ❑ Legally simple
- ❑ Relatively inexpensive
- ❑ No title transfer of property or assets

■ **Disadvantage:**

- ❑ Must be approved by stockholder vote within each entity
-

Purchasing Voting Stock

- One company purchases the voting stock in another company in exchange for cash, stock in the existing company, or both.
 - Done through a tender offer
 - No shareholders' meetings are needed, and management may be bypassed.
 - Buyer goes directly to shareholders; if majority agree to sell, the purchaser gains control of the business.
-

Purchasing Assets

- One company purchases the assets of another company.
 - Least common of the three methods. Rarely done in the sport industry.
 - Benefit
 - Acquiring company can increase its inventory or capital assets without acquiring potential liability, debt, or other concerns from the seller.
 - The legal process can be very costly.
-

Questions for Class Discussion

- DQ1: How does the statement of cash flows differ from the income statement? What do the operating activities, investing activities and financing activities tell us about cash events?
 - DQ2: What is depreciation and why is it considered a noncash item?
 - *Requirements: 250 words minimum initial post, 100 words minimum reply*
-

Unit Recap: Key Terms

- **Balance sheet:** A document displaying the financial condition of a business at a single point in time. Basic definition: $\text{assets} = \text{liabilities} + \text{owner's equity}$.
 - **Income statement:** A document describing how much profit or loss was earned by a business over a given length of time.
 - **Statement of cash flows:** A document providing information about how the cash position of a business has changed over a given period of time
 - **Depreciation:** The cost of equipment and property used by the organization in the process of producing and distributing goods and services.
 - **Intangible assets:** Nonphysical assets of the business providing value (e.g., goodwill, patents, licenses, trademarks, copyrights).
 - **Cost of goods sold:** Those expenses that are directly related to the production and distribution of goods and services (may be referred to as cost of sales). This includes raw materials, direct labor, and manufacturing overhead. Selling costs and general and administrative costs have separate lines.
-

Unit Recap: Key Terms, cont.

- **Assets:** Any resource or goods that might offer future benefits to a business and have value. Assets are listed according to the length of time it takes to convert them to cash.
- **Liquidity:** The ease and quickness with which assets can be converted to cash.
- **Liability:** Any legal or financial obligation (e.g., debt, retained earnings, shareholders' equity, taxes owed). Listed on the balance sheet according to the length of time it takes to convert them to cash.
- **Revenue:** Money coming into a business.
- **Expenses:** Money going out of a business (payments; reduction in value, or depreciation; new legal obligations).

Unit Recap: Key Terms, cont.

- **Market value of a firm:** Based on what stock buyers and sellers establish when they buy and sell shares in the business (true “street value” of the business).
- **Book value (also called owners’ equity):** Based on the historic cost of assets minus accumulated depreciation (does not necessarily represent true replacement value of an asset).
- **Owners’ equity:** Calculated by adding retained earnings and the value of common stocks (this calculation is also known as net worth).
- **Book value per share:** The amount of the firm’s value an individual stockholder has.

Unit Recap: Sample Balance Sheet, Income Statement, and Statement of Cash Flows

- Sample Balance Sheet: Turn to figure 6.1 found in Chapter 6 of the text.
 - Sample Income Statement: Turn to figure 6.2 found in Chapter 6 of the text.
 - Sample Statement of Cash Flows: Turn to figure 6.3 found in Chapter 6 of the text.
 - *Additionally, review the Khan Academy videos, attached to this unit, to better understand these three statements.*
-

References

■ **Required Textbook:**

Fried, G., Shapiro, S., & DeSchrive, T. (2013). *Sport Finance*, (3rd ed.). Champaign, IL: Human Kinetics.
ISBN 13: 9781450421041
