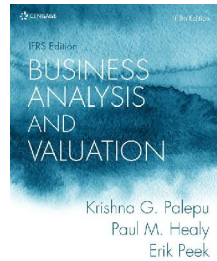


Framework for Business Analysis and Valuation Using Financial Statements

Chapter 1



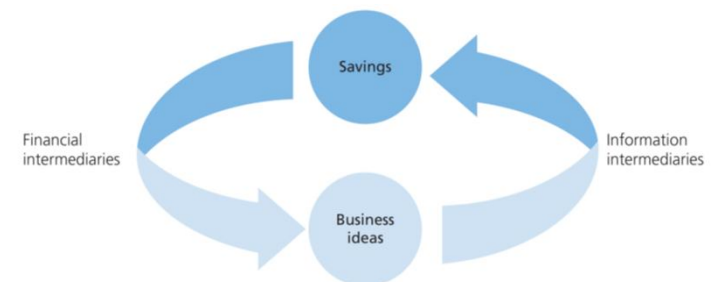
KEY CONCEPTS IN CHAPTER 1

- Financial statements are an important source of information to the capital markets and business analysts.
- Analyzing financial statements addresses a number of issues of interest to external stakeholders and company insiders.

THE ROLE OF FINANCIAL REPORTING IN CAPITAL MARKETS

- Financial reporting provides much-needed information to capital market participants
 - Financial intermediaries depend upon the information in financial statements to evaluate investment opportunities.
 - Information intermediaries assure the quality of financial statement representations.
 - Relevant and reliable financial information is essential for the functioning of capital markets.

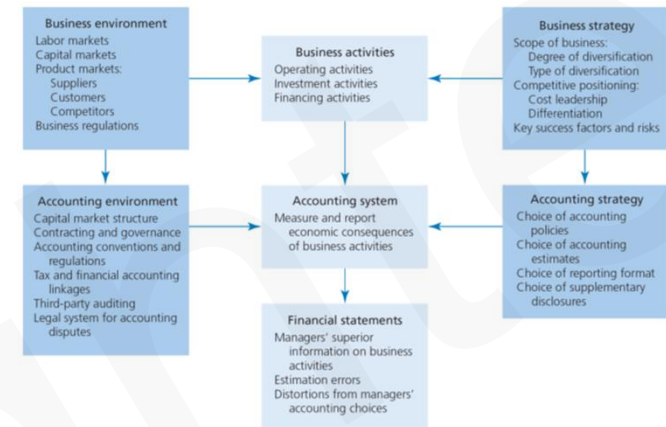
HOW CAPITAL MARKETS FUNCTION



FROM BUSINESS ACTIVITIES TO FINANCIAL STATEMENTS

- Financial statements measure and summarize the economic consequences of business activities.
- Accounting systems facilitate information quality.
 - The role of accrual accounting.
 - The need for accounting conventions and standards.
 - Managers' accounting choices and strategies.
 - Auditing and the quality of financial information.

FROM BUSINESS ACTIVITIES TO FINANCIAL STATEMENTS



ACCRUAL ACCOUNTING

- Financial reports are prepared using accrual accounting instead of cash accounting.
 - Expected cash receipts from the delivery of products or services are recognized as revenues, and expected cash outflows associated with these revenues are recognized as expenses.
 - Timing differences between the moment of recording costs or benefits and the moment of experiencing cash inflows or outflows result in the recognition of assets and liabilities on the balance sheet.
- IFRS defines the following financial statement elements:
 - Assets
 - Liabilities
 - Equity
 - Income or Revenue
 - Expenses
 - Profit or Loss

MANAGEMENT'S RESPONSIBILITY FOR REPORTING FINANCIAL INFORMATION

- Applying accounting principles is the responsibility of management, who has superior knowledge of a firm's business.
- Incentives exist for management to distort accounting numbers in their favour.
 - Contracts
 - Reputation
- Mitigating effects of legal liability, auditing, public enforcement.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

- The EU and other countries worldwide have relied on the IASB to set accounting standards (IFRS); many countries have endorsement procedures.
- IFRS allows for consistency in reporting between firms and over different time periods of the same firm.
- Uniform accounting standards minimize manager's ability to manipulate financial statement information.
- Rigid accounting rules may be dysfunctional; calls for principles-based accounting standards.

EXTERNAL AUDITING OF FINANCIAL STATEMENTS

- Required for publicly traded companies; within the EU also required for some private firms.
- Conducted according to standards:
 - EU: minimum standards set by the Revised Statutory Audit Directive and Regulation (US: Sarbanes-Oxley Act)
 - International Standards of Auditing (US: GAAS)
- Auditing has its limitations; it is backed up by legal liability and public enforcement.

PUBLIC ENFORCEMENT

- Most countries have public enforcement bodies to review compliance and take actions to correct noncompliance.
- Public enforcement cannot ensure full compliance because enforcement bodies work:
 - Proactively on a sampling basis or
 - On a complaint basis
- There is international diversity in enforcement quality; the ESMA (European Securities and Markets Authority) coordinates enforcement activities in the EU

FACTORS INFLUENCING ACCOUNTING QUALITY

- It is necessary to allow managers some discretion in applying accounting standards.
- As a result, three potential sources of noise and bias in accounting data include:
 1. Noise from accounting rules
 2. Forecast errors
 3. Manager's accounting choices

NOISE FROM ACCOUNTING RULES AND FORECAST ERRORS

- The fit between accounting standards and the nature of the firm's transactions may introduce some distortion in the reported financial statements.
- Management's estimates may result in accounting forecasting errors reflected in the financial statements.

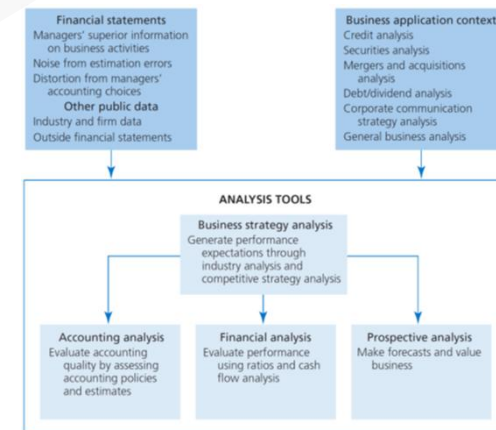
ALTERNATE FORMS OF INVESTOR COMMUNICATION

- Analyst meetings
 - Regular meetings with analysts releases information to these intermediaries.
 - Material information released to analysts must also be publicly disclosed.
- Voluntary disclosure
 - Management has the discretion to voluntarily disclose information, though there are constraints on this type of disclosure.

FINANCIAL STATEMENTS AND BUSINESS ANALYSIS

- Business intermediaries use financial statements to accomplish four key objectives:
 - Business strategy analysis
 - Accounting analysis
 - Financial analysis
 - Prospective analysis

BUSINESS STRATEGY ANALYSIS





CONCLUDING COMMENTS

- Financial statements are a source of widely available data on publicly traded corporations.
- Accrual accounting attempts to accurately reflect expectations of economic performance, but requires careful analysis.