

Business Analysis and Valuation :

Using Financial Statements

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Chapter 1 A Framework for Business Analysis and Valuation Using Financial Statements

1.1 THE ROLE OF FINANCIAL REPORTING IN CAPITAL MARKETS

▶ “lemons” problem

A critical challenge for any economy is the allocation of savings to investment opportunities. Economies that do this well can exploit new business ideas to spur innovation and create jobs and wealth at a rapid pace. In contrast, economies that manage this process poorly dissipate^① their wealth and fail to support business opportunities.

Figure 1-1 P1-2

First, entrepreneurs typically **have better information than savers** on the value of business investment opportunities.

Second, communication by entrepreneurs to investors is not completely credible because investors know entrepreneurs have an incentive to **inflate the value of their ideas**.

These information and incentive problems lead to what economists call the **“lemons”** problem, which can potentially **break down** the functioning of the capital market. It works like this.

Consider a situation where half the business ideas are “good” and the other half are “bad.” If investors cannot distinguish between the two types of business ideas entrepreneurs with “bad” ideas will try to claim that their ideas are as valuable as the “good” ideas. Realizing this

^① dissipate [简明英汉词典][disipeit]v.驱散, (使)(云、雾、疑虑等)消散, 浪费(金钱或时间)

possibility, investors value both good and bad ideas at an average level, unfortunately, this penalizes good ideas, and entrepreneurs with good ideas find the terms on which they can get financing to be unattractive. As these entrepreneurs leave the capital market, the proportion of bad ideas in the market increases. Over time, bad ideas “crowd out” good ideas, and **investors lose confidence in this market**.

► Intermediaries

The emergence of intermediaries can prevent such a market breakdown. Intermediaries are like a car mechanic who provides an independent certification of a used car's quality to help a buyer and seller agree on a price.

Two types of intermediaries in the capital markets.

Financial Intermediaries: venture capital firms, banks, [mutual funds](#), and insurance companies; focus on aggregating funds from individual investors and analyzing different investment alternatives to make investment decisions.

Information intermediaries: auditors, financial analysts, bond-rating agencies, and the financial press, focus on providing information to investors (and to financial intermediaries who represent them) on the quality of various business investment opportunities.

Both these types of intermediaries add value by helping investors distinguish “good” investment opportunities from the “bad” ones.

Financial reporting plays a critical role in the functioning of both the information intermediaries and financial intermediaries. Information intermediaries add value by either **enhancing the credibility of financial reports (as auditors do)**, or by **analyzing the information in the financial statements (as analysts and the rating agencies do)**. Financial intermediaries rely on the information in the financial statements to analyze investment opportunities, and supplement this information with other sources of information. In the following section, we discuss key aspects of the financial reporting system design that enable it to play effectively this vital role in the functioning of the capital markets.

1.2 FROM BUSINESS ACTIVITIES TO FINANCIAL STATEMENTS

1.2.1 The relationship between business and accounting

Value is created when the firm earns a return on its investment in excess of the cost of capital.

A firm's business activities are influenced by its **economic environment** and its **own business strategy**. The economic environment includes the firm's industry, its input and output markets, and the regulations under which the firm operates. The firm's business strategy determines how the firm positions itself in its environment to achieve a competitive advantage.

Figure I-2, P1-4

Financial statements **summarize** the economic consequences of its business activities

Qs:

Intermediaries using financial statement data to do business analysis have to be aware that **financial reports are influenced** both by the **firm's business activities** and by its **accounting system**.

1.2.2 understanding the influence of the accounting system on the quality of the financial statement data

A key aspect of financial statement analysis involves understanding the **influence of the accounting system on the quality of the financial statement data** being used in the analysis.

The institutional features of accounting systems discussed below determine the extent of that influence.

Accounting System Feature 1: Accrual Accounting

One of the fundamental features of corporate financial reports is that they are prepared **using accrual rather than cash accounting**. Unlike cash accounting, accrual accounting distinguishes between the recording of costs and benefits associated with economic activities and the actual payment and receipt[^] of cash. **Net income is the primary periodic performance index under accrual accounting**.

Eg. Accounts receivables, Accounts payables,

To compute net income, the effects of economic transactions are recorded on the basis of **expected** not necessarily **actual**, cash receipts and payments. 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.

The need for accrual accounting arises from investors' demand for financial reports on a periodic basis. Because firms undertake economic transactions on a continual basis, the arbitrary closing of accounting books at the end of a reporting period leads to a fundamental measurement problem. Since cash accounting does not report the full economic consequence of the transactions undertaken in a given period, accrual accounting is designed to provide more complete information on a firm's periodic performance.

Accounting System Feature 2: Accounting Standards (GAAP) and Auditing

(1) Accounting data is cooked by people.

The use of accrual accounting lies at the center of many important complexities in corporate financial reporting. Because accrual accounting deals with expectations of future cash consequences of current events, **it is subjective and relies on a variety of assumptions. Who should be charged with the primary responsibility of making these assumptions? A firm's managers** are entrusted with the task of making the appropriate estimates and assumptions to prepare the financial statements because they have intimate knowledge of their firm's business.

Two motivations:

The accounting discretion granted to managers is potentially valuable because it allows them to reflect inside information in reported financial statements. However, since **investors view profits as a measure of managers' performance**, managers have **incentives to use their accounting discretion to distort reported profits by making biased assumptions.**

Further, the use of accounting numbers in contracts between the firm and outsiders provides another motivation for management manipulation of accounting numbers. **Income management distorts financial accounting data**, making them less valuable to external users of financial statements. Therefore, the delegation of financial reporting decisions to corporate managers has both costs and benefits.

(2) Accounting standards (GAAP)

A number of accounting conventions have evolved to ensure that managers use their accounting flexibility to summarize their knowledge of the firm's business activities, and not to disguise reality for self-serving purposes. For example, the **measurability and conservatism conventions** are accounting responses to concerns about distortions from managers' potentially optimistic bias. Both these conventions attempt to limit

managers' optimistic bias by imposing their own pessimistic bias.

Accounting standards, called Generally Accepted Accounting Principles (GAAP), promulgated by the Financial Accounting Standards Board (FASB) and similar standard setting bodies in other countries, also limit potential distortions that managers can introduce into reported numbers. Uniform accounting standards attempt to reduce managers' ability to record similar economic transactions in dissimilar ways, either over time or across firms.

(3) Opposite effects——at the expense of reduced flexibility

Eg. R&D

Increased uniformity from accounting standards, however, comes at the expense of reduced flexibility for managers to reflect genuine business differences in their firm's financial statements.

Rigid accounting standards work best for economic transactions whose accounting treatment is not predicated on managers' proprietary information.

However, when there is significant business judgment involved in assessing a transaction's economic consequences, rigid standards which prevent managers from using their superior business knowledge would be dysfunctional. Further, if accounting standards are too rigid, they may induce managers to expend economic resources to restructure business transactions to achieve a desired accounting result.

非生产性的盈余管理：例如将自己的房产低价租赁出去，然后再高价租赁回来。

(4) Auditing

Auditing, broadly defined as a verification of the integrity of the reported financial statements by someone other than the preparer, ensures that managers use accounting rules and conventions consistently over time, and that their accounting estimates are reasonable. Therefore auditing improves the quality of accounting data.

Third-party auditing may also reduce the quality of financial reporting because it constrains the kind of accounting rules and conventions that evolve over time. For example, the FASB considers the views of auditors in the standard-setting process. Auditors are likely to argue against accounting standards producing numbers that are difficult to audit, even if the proposed rules produce relevant information for investors.

(5)

The legal environment in which accounting **disputes between managers, auditors, and investors** are adjudicated can also have a significant effect on the quality of reported numbers. **The threat of lawsuits and resulting penalties have the beneficial effect of improving the accuracy of disclosure.**

However, the potential for a significant legal liability might also **discourage** managers and auditors from supporting accounting proposals requiring risky forecasts, such as **forward-looking[®] disclosures.**

Accounting System Feature 3: Managers' Reporting Strategy

(1)

Because the mechanisms[^] that limit managers ability to distort accounting data add noise, **it is not optimal to use accounting regulation to eliminate managerial flexibility completely.**

Therefore **real-world accounting systems leave considerable room for managers to influence financial statement data.**

A firm's **reporting strategy**, that is, **the manner in which managers use their accounting discretion**, has an important influence on the firm's financial statements.

(2)

Corporate managers can choose accounting and disclosure policies that make it more or less difficult for external users of financial reports to understand the true economic picture of the businesses. **Accounting rules often provide a broad set of alternatives from which managers can choose.** Further, managers are entrusted with making a range of estimates in implementing these accounting policies.

Accounting regulations usually prescribe minimum disclosure requirements, but they do not restrict managers from voluntarily providing additional disclosures.

(3)

A superior disclosure strategy will enable managers to communicate the underlying business reality to outside investors.

(competitive dynamics, performance)

(4)

Managers can also use financial reporting strategies to **manipulate investors' perceptions.**

Optimistic assessment of the true performance, or **controlling the extent of information** that is disclosed voluntarily.

[®] 高瞻远瞩的, 进取的

1.3 FROM FINANCIAL STATEMENTS TO BUSINESS

ANALYSIS

The process through which analysts can **separate noise** from information in financial statements, and **gain valuable business insights** from financial statements analysis, is discussed next.

Because managers' insider knowledge is a source both of value and distortion in accounting data, it is difficult for outside users of financial statements to separate true information from distortion and noise. Not being able to undo accounting distortions completely, investors "discount" a firm's reported accounting performance. In doing so, they make a probabilistic assessment of the extent to which a firm's reported numbers reflect economic reality. As a result, investors can have only an **imprecise assessment** of an individual firm's performance. **Financial and information intermediaries can add value by improving investors' understanding of a firm's current performance and its future prospects.**

Effective financial statement analysis is valuable because it attempts to get at managers' inside information from public financial statement data. Because intermediaries do not have direct or complete access to this information, they rely on their knowledge of the **firm's industry and its competitive strategies** to **interpret** financial statements. Successful intermediaries have at least as good an understanding of the industry economics as do the firm's managers as well as a reasonably good understanding of the firm's competitive strategy.

Although outside analysts have an information disadvantage relative to the firm's managers, they are more objective in evaluating the economic consequences of the firm's investment and operating decisions.

Figure I-3 (P1-7) provides a schematic overview of how business intermediaries use financial statements to accomplish four key steps:

- (1) **business strategy analysis,**
- (2) **accounting analysis,**
- (3) **financial analysis**
- (4) **prospective analysis.**

1.2.1 Analysis Step 1: Business Strategy Analysis

The purpose of business strategy analysis is to identify key **profit drivers and**

business risks, and to assess the company's profit potential **at a qualitative level**.

Business strategy analysis **involves** analyzing **a firm's industry** and its strategy to create a **sustainable competitive advantage**.

This qualitative analysis is an essential first step because it enables the analyst to **frame the subsequent accounting and financial analysis better**.

For example, identifying the key success factors and key business risks allows the identification of key accounting policies. Assessment of a firm's competitive strategy facilitates evaluating whether current profitability is sustainable.

Finally, **business analysis enables the analyst to make sound assumptions in forecasting a firm's future performance**.

1.2.2 Analysis Step 2: Accounting Analysis

The purpose of accounting analysis is to **evaluate the degree** to which a firm's accounting captures the underlying **business reality** by identifying places where there is accounting **flexibility**, and by evaluating the **appropriateness of the firm's accounting policies and estimates**, analysts can assess the degree of **distortion** in a firm's accounting numbers.

Another important step in accounting analysis is to **"undo"** any accounting distortions by **recasting** a firm's accounting numbers to create unbiased accounting data. **Sound accounting analysis improves the reliability of conclusions from financial analysis**, the next step in financial statement analysis.

1.2.3 Analysis Step 3: Financial Analysis

The goal of financial analysis is to use financial data to evaluate the current and past performance of a firm and to assess its sustainability.

There are two important skills related to financial analysis.

First, the analysis should be **systematic and efficient**.

Second, the analysis should allow the analyst to **use financial data to explore business issues**.

Ratio analysis and cash flow analysis are the two most commonly used financial tools. Ratio analysis focuses on evaluating a firm's **product market performance and financial policies**; cash flow analysis focuses on a firm's **liquidity and financial flexibility**.

1.2.4 Analysis Step 4: Prospective Analysis

Prospective analysis, which focuses on **forecasting a firm's future**, is the final step in business analysis.

Two commonly used techniques in prospective analysis are **financial statement forecasting and valuation**. Both these tools allow the synthesis of the insights from business analysis, accounting analysis, and financial analysis in order to make predictions about a firm's future.

While the value of a firm is a function of its future cash flow performance, it is also possible to assess a firm's value based on the firm's current **book value of equity**, and its future **return on equity (ROE)** and growth.

Strategy analysis, accounting analysis, and financial analysis, the first three steps in the framework discussed here, provide an **excellent foundation for estimating a firm's intrinsic value**. **Strategy analysis**, in addition to enabling sound accounting and financial analysis, also helps in assessing potential changes in a firm's competitive advantage and their implications for the firm's future ROE and growth. **Accounting analysis** provides an unbiased estimate of a firm's current book value and ROE. **Financial analysis** allows you to gain an in-depth understanding of what drives the firm's current ROE.

1.4 Understanding about the four steps

The Predictions from a sound business analysis are useful to a variety of parties and can be applied in various contexts. The exact nature of the analysis will depend on the context.

The **contexts** that we will examine include **securities analysis, credit evaluation, mergers and acquisitions, evaluation of debt and dividend policies, and assessing corporate communication strategies**. The four analytical steps described above are useful in each of these contexts.

Appropriate use of these tools requires a **familiarity with the economic theories and institutional factors relevant to the context**.

There are several ways in which **financial statement analysis can add value**, even when capital markets are reasonably efficient.

First, there are many applications of financial statement analysis whose focus is outside the capital market context: credit analysis, competitive benchmarking, analysis of mergers and acquisitions, to name a few.

Second, markets become efficient precisely because some market participants rely on analytical tools such as the ones we discuss in this book to analyze information and make investment decisions.

1.5 SUMMARIES

Financial statements provide the most widely available data on public corporations' economic activities; investors and other stakeholders rely on them to assess the plans and performance of firms and corporate managers.

Accrual accounting data in financial statements are noisy, and unsophisticated investors can assess firms' performance only imprecisely.

Financial analysts who understand managers' disclosure strategies have an opportunity to create inside information from public data, and they play a valuable role in enabling outside parties to evaluate a firm's current and prospective performance.

This chapter has outlined the framework for business analysis with financial statements, using the four key steps.

1.6 Discussion questions

(1) Accounting statements rarely report financial performance without error. List three types of errors that can arise in financial reporting.

(2) Four steps for business analysis re discussed in the chapter. As a financial analyst, explain why each of these steps is a critical part of your job and how they relate to one another.

1.7 Mutual Funds return (共同基金 , 信托基金)

Mutual funds have become **one of the most attractive ways** for the average person to invest their money. A mutual fund pools resources from thousands of investors and then diversifies its investment into many different holdings such as stocks, bonds, or government securities in order to provide high relative safety and returns.

Though not FDIC insured like banks, mutual funds generally provide more return than the current one to two percent obtainable through banks while still being one of the safest ways to grow your money. There are an endless variety of mutual fund investment choices depending on the degree of risk you feel comfortable with.

Most funds also offer retirement plan choices such as SEP, Traditional IRA, and Roth IRA. Things to investigate before you invest in a mutual fund are how long the fund has been in existence, average annual rate of return, the tenure of the fund managers, your investment objectives, type of companies the fund invests in, and costs the fund charges.

This site is determined to help in your mutual fund research and selection process because the proper fund will go a long way in meeting your long and short-term investment needs.