Chapter 1

A Framework for Business Analysis and Valuation
Using Financial Statements

Discussion Questions

1. John, who has just completed his first finance course, is unsure whether he should take a course in business analysis and valuation using financial statements, since he believes that financial analysis adds little value, given the efficiency of capital markets. Explain to John when financial analysis can add value, even if capital markets are generally seen as being efficient.

The efficient market hypothesis states that security prices reflect all available information, as if such information could be costlessly digested and translated immediately into demands for buys or sells. The efficient market hypothesis implies that there is no further need for analysis involving a search for mispriced securities.

However, if all investors adopted this attitude, no equity analysis would be conducted, mispricing would go uncorrected, and markets would no longer be efficient. This is why there must be just enough mispricing to provide incentives for the investment of resources in security analysis.

Even in an extremely efficient market, where information is fully impounded in prices within minutes of its revelation (i.e., where mispricing exists only for minutes), John can get rewards with strong financial analysis skills:

1. John can interpret the newly announced financial data *faster* than others and trade on it within minutes; and

2. Financial analysis helps John to understand the firm better, placing him in a better position to interpret other news *more accurately* as it arrives.

Markets may be not efficient under certain circumstances. Mispricing of securities may exist days or even months after the public revelation of a financial statement when the following three conditions are satisfied:

1. relative to investors, managers have superior information on their firms’ business strategies and operation;

2. managers’ incentives are not perfectly aligned with all shareholders’ interests; and

3. accounting rules and auditing are imperfect.

When these conditions are met in reality, John could get profit by using trading strategies designed to exploit any systematic ways in which the publicly available data are ignored or discounted in the price-setting process.

Capital in market efficiency is not relevant in some areas. John can get benefits by using financial analysis skills in those areas. For example, he can assess how much value can be created through acquisition of target company, estimate the stock price of a company considering initial public offering, and predict the likelihood of a firm’s future financial distress.

***2. In 2009, Larry Summers, former Secretary of the Treasury, observed that “in the past 20-year period, we have seen the 1987 stock market crash. We have seen the Savings & Loan debacle and commercial real estate collapse of the late 80’s and early 90’s. We have seen the Mexican financial crisis, the Asian financial crisis, the Long Term Capital Management liquidity crisis, the bursting of the NASDAQ bubble and the associated Enron threat to corporate governance. And now we’ve seen this [global economic crisis], which is more serious than any of that. Twenty years, 7 major crises. One major crisis every 3 years.” How could this happen given the large number of financial and information intermediaries working in financial markets throughout the world? Can crises be averted by more effective financial analysis?***

Financial intermediaries perform a variety of functions that are designed to mitigate problems in our financial markets.

Auditors certify the credibility of financial reports; audit committees hire the external auditors and oversee both the internal and external auditors to ensure that they do a thorough job of assuring the company’s financial information is reliable and not fraudulent. Corporate boards are tasked with monitoring and appointing the firm’s CEO and with overseeing its strategy. Financial analysts evaluate a firm’s financial performance and valuation and assess whether a stock is a worthwhile investment, and also ensure that there is common information on a stock in the market to reduce adverse selection problems. Investment banks help to provide good companies with access to capital and to help insure that investors can allocate capital to good businesses. And so the list goes on, including investment managers, hedge fund managers, and the business press.

It is an interesting question as to why these various institutions failed to detect the problems underlying the crisis identified by Larry Summers. One explanation is that they face their own conflicts of interest. Auditors have certainly received criticism for audit failures. Some suggest that this arises because auditors are (perhaps unconsciously) reluctant to take a hard line against important clients for fear of losing the account. Similar concerns have been raised about financial analysts, which either worry about the reactions of corporate managers, major clients, or investment bankers at their firm if they write negative reports about companies they follow. Corporate boards have been criticized for being beholden to the senior executives of the companies they oversee. Recent governance changes were intended to correct some of these conflicts of interest. For example, in the U.S. the Sarbanes Oxley Act was intended to give Audit Committees more clout and change the incentives of auditors. The Global Financial Settlement and Regulation Fair Disclosure were intended to reduce the conflicts of interest for financial analysts. Many of these changes were also implemented outside the U.S. However, it is difficult to eliminate the conflicting incentives of intermediaries, who by their nature are in the difficult position of trying to work for two bosses.

A second potential explanation is that human beings are subject to behavioral biases that lead them to make common mistakes. For example, most retail investors extrapolated performances at Enron, internet stocks, and mortgage backed securities to conclude that these would continue to be terrific investments. They poured money into these sectors and stocks and showed little interest in hearing from analysts, auditors, investment bankers, etc. who had a contrarian point of view. For example, at the height of the internet boom, Warren Buffet expressed concern about the sector but was dismissed as a dinosaur who didn’t understand the new economy. Less informed or less confident intermediaries would find it difficult to challenge the popular view of such hot markets or to judge when such hot markets would crash.

Given these problems, we will probably continue to have crises unless we can correct the fundamental conflicts of interest that pervade the industry and can figure out how to modify human behavior.

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

Three types of potential errors in financial reporting include:

1. error introduced by rigidity in accounting rules;

2. random forecast errors; and

3. systematic reporting choices made by corporate managers to achieve specific objectives.

**Accounting Rules.** Uniform accounting standards may introduce errors because they restrict management discretion of accounting choice, limiting the opportunity for managers’ superior knowledge to be represented through accounting choice. For example, SFAS No. 2 requires firms to expense all research and development expenditures when they are occurred. Note that some research expenditures have future economic value (thus, to be capitalized) while others do not (thus, to be expensed). SFAS No. 2 does not allow managers, who know the firm better than outsiders, to distinguish between the two types of expenditures. Uniform accounting rules may restrict managers’ discretion, forgo the opportunity to portray the economic reality of firm better and, thus, result in errors.

**Forecast Errors.** Random forecast errors may arise because managers cannot predict future consequences of current transactions perfectly. For example, when a firm sells products on credit, managers make an estimate of the proportion of receivables that will not be collected (allowance for doubtful accounts). Because managers do not have perfect foresight, actual defaults are likely to be different from estimated customer defaults, leading to a forecast error.

**Managers’ Accounting Choices.** Managers may introduce errors into financial reporting through their own accounting decisions. Managers have many incentives to exercise their accounting discretion to achieve certain objectives, leading to systematic influences on their firms’ reporting. For example, many top managers receive bonus compensation if they exceed certain prespecified profit targets. This provides motivation for managers to choose accounting policies and estimates to maximize their expected compensation.

4. Joe Smith argues that “learning how to do business analysis and valuation using financial statements is not very useful, unless you are interested in becoming a financial analyst.” Comment.

Business analysis and valuation skills are useful not only for financial analysts but also for corporate managers and loan officers. Business analysis and valuation skills help corporate managers in several ways. First, by using business analysis for equity security valuation, corporate managers can assess whether the firm is properly valued by investors. With superior information on a firm’s strategies, corporate managers can perform their own equity security analysis and compare their estimated “fundamental value” of the firm with the current market price of share. If the firm is not properly valued by outside investors, corporate managers can help investors to understand the firm’s business strategy, accounting policies, and expected future performance, thereby ensuring that the stock price is not seriously undervalued.

Second, using business analysis for mergers and acquisitions, corporate managers (acquiring management) can identify a potential takeover target and assess how much value can be created through acquisition. Using business analysis, target management can also examine whether the acquirer’s offer is a reasonable one.

Loan officers can also benefit from business analysis, using it to assess the borrowing firm’s liquidity, solvency, and business risks. Business analysis techniques help loan officers to predict the likelihood of a borrowing firm’s financial distress. Commercial bankers with business analysis skills can examine whether or not to extend a loan to the borrowing firm, how the loan should be structured, and how it should be priced.

5.  Four steps for business analysis are discussed in the chapter (strategy analysis, accounting analysis, financial analysis, and prospective analysis). As a financial analyst, explain why each of the four steps is a critical part of your job, and how they relate to one another.

Managers have better information on a firm’s strategies relative to the information that outside financial analysts have. Superior financial analysts attempt to discover “inside information” from analyzing financial statements. The four steps for business analysis help outside analysts to gain valuable insights about the firm’s current performance and future prospects.

1. Business strategy analysis is an essential first step because it enables the analysts to frame the subsequent accounting, financial, and prospective 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 strategy analysis enables the analysts to make sound assumptions in forecasting a firm’s future performance.
2. Accounting analysis enables the analysts to “undo” any accounting distortion by recasting a firm’s accounting numbers. Sound accounting analysis improves the reliability of conclusions from financial analysis.
3. The goal of financial analysis is to use financial data to evaluate the performance of a firm. The outcome from financial analysis is incorporated into prospective analysis, the next step in financial statement analysis.
4. Prospective analysis synthesizes the insights from business strategy analysis, accounting analysis, and financial analysis in order to make predictions about a firm’s future.