

Financial statement analysis:

Lecture 1 – Introduction:

What is value and how is it created?

- Central to Valuations and Financial Statement Analysis is understanding value
 - What is the value of the firm?
 - How is value created in the firm?
 - Value of a function of returns
- A firm **creates value** when it earns a return greater than the cost of capital

The context?

- Firms exist because they are economically efficient mechanisms for undertaking business activities. They should create value
 - Coase (1937)
 - Alchian and Demsetz (1972)
 - Williamson (1981)
- What are the questions that everyone wants the answers to?
 - What is the value of the firm?
 - How is the value of the firm changing?
- Business analysis focuses on these questions

What is the role of financial reporting?

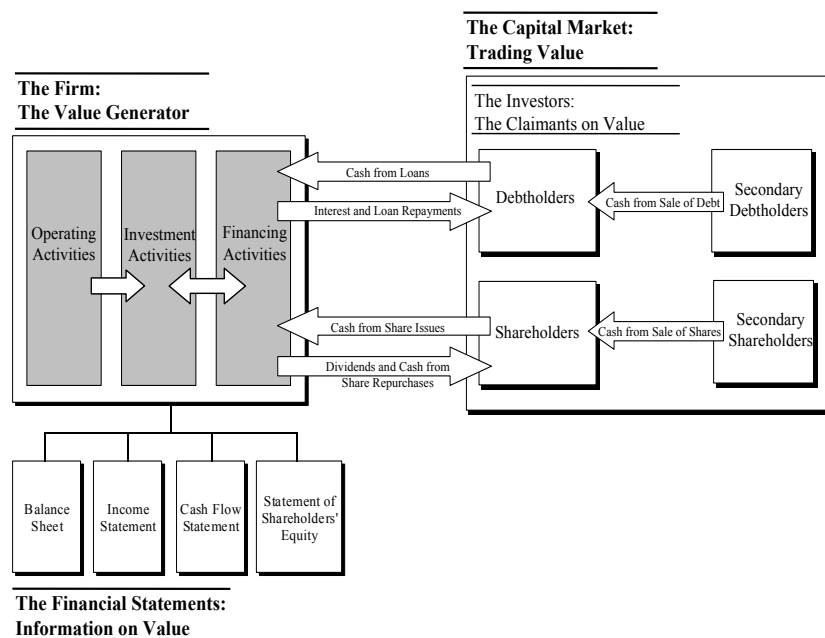
- The provision of information to support decision making and the efficient allocation of resources to the firm
 - Equity holders
 - Debt holders
 - Employees

Why analyse financial statements to find value?

- Financial statements provide the most widely available data on a company's economic activities.
- The role of financial statements is to summarise the economic consequences of a firm's business activities – returns - value.

Understanding the activities of the firm and value creation:

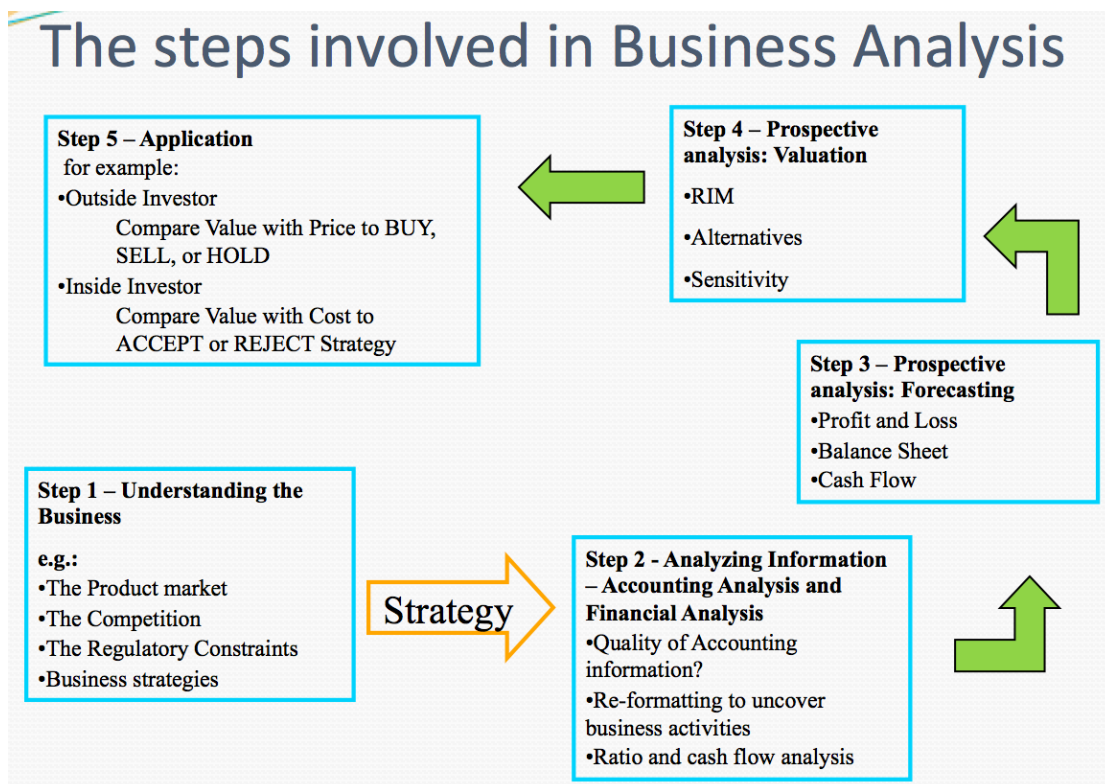
- Critical is the identification of what creates value within the firm.



- To facilitate Business Valuation and Financial Statement Analysis, and understanding value and value creation, the economic activities of the firm are divided into 3 broad categories:
 - Operating activities
 - Investing activities
 - Financing activities

Business activities and financial statements:

- Financial statements are a window on the activities of the firm:
 - Economic environment
 - Business strategies
 - Accounting
- So: financial statements are influenced by:
 - Economic events / business activities
- And
 - The accounting system
 - Accrual accounting
 - GAAP standards and audit
 - Management's reporting strategies



Who undertakes BV and FSA?

- Equity Investors
 - Investment analysis
 - Management performance evaluation
- Debt Investors
 - Probability of default
 - Determination of lending rates
 - Covenant violations
- Management
 - Strategic planning
 - Investment in operations
 - Evaluation of subordinates

- Employees
 - Security and remuneration
- Litigants
 - Disputes over value in the firm
- Customers
 - Security of supply
- Governments
 - Policy making
 - Regulation
 - Taxation
 - Government contracting
- Competitors
- Auditors
- Students