REVISION CORPORATE FINANCIAL ANALYSIS

Week 1: TOP DOWN ANALYSIS

Tutorial 2 lecture 2 INDUSTRY AND STRATEGY ANALYSIS

Week 1 → 5 step of financial statement analysis

1. **Identify economic characteristic of the industry**
   - Common size analysis, value change, Porter's Five Forces, economic attribute frame work
2. **Identify strategies that firm use (explained below)**
   - Cost leadership
   - Differentiate
   - Focus: on a niche market
   - ➔ Economic attribute framework
     - 1.1. Demand (price sensitive? Growth? Economic crisis?)
     - 1.2. Supply (competition? berries to entries?)
     - 1.3. Manufacturing (Capital intensive? Labor intensive?)
     - 1.4. Marketing
     - 1.5. Investing and Financing
   - ➔ **Porter competitive advantage framework**
     - 1.1. Select attractive industry using the 5 forces
     - 1.2. Apply competitive advantage strategy
     - 1.3. Develop attractive value chain
   - ➔ **Frame work for strategy analysis**
     - 1.1. Natural of product or services (high or low profit?)
     - 1.2. Degree of integration with value chain (Vertical or different phrase)
     - 1.3. Degree of geographic diversification (other countries = growth, risk)
     - 1.4. Degree of industry diversification (Single or multiple industry)
3. **Assess the quality of financial statement (Accounting quality)**

Accounting information should be fair and truly reflect the firm economic, performance, position and risk + Provide information for future earning, forecasting of future cash flow.

The purpose of Accounting Analysis is to evaluate the degree to which the firm's accounting captures its underlying business reality

Accounting quality → how well it tell us what happened?

Accounting rules → gonna effect accounting quality

Forecast error → future to accride

<u>Financial reporting – the institutional framework</u>

The basic features of financial reporting:

- **Accrual accounting** - effects of economic transactions are recorded on the basis of expected, not necessarily actual, cash receipts and payments.
  – Note: guesses → will not completely reflect underlying business reality

- **Delegation of reporting to management**
- **Generally accepted accounting principles** – to limit choice for mgmt (e.g. LIFO)
  - Move from Aus GAAP to IFRA
- **External auditing** – ensures mgmt use accounting rules and conventions consistently over time
  - Ensuring info is materially correct
- **Legal liability** – threat of lawsuits, penalties for fraudulent activity etc…
  - E.g. Forward estimates → mgmt don't provide them due to potential of being sued

<u>**Factors influencing Accounting Quality**</u>

- **Accounting rules** – introduce bias because it is often difficult to restrict mgmt discretion without reducing information content of accounting data
- **Forecast errors** – mgmt cannot predict future consequences of current transactions accurately/perfectly.
- **Manager's accounting choices** – incentives to exercise accounting discretion to achieve certain objectives, leading to systematic influences on their firms' reporting (e.g. mgmt compensation)

4. Analyze future profitability and risk

1.1. Using common size analysis for easy comparison between firm in different size as it express items or the whole financial statement in relation to an item or a base of the fin statement, easy to compare with other firm and over time → here, use it to compare year to year

1.2. Percentage change statement highlight the change in the items of the financial statement over time

1.3. Financial statement ratios (Profitability ratio: EPS, ROA, ROE, ROCE; risk ratio: D/E, standard deviation of ROA, ROE and ROCE)

5. Value the firm

Use valuation model like DCF, LBO, Comparable company analysis, ROIC, RIC, or DDM

Forecast accounting data, like it with return.

The market Is not efficiency, some underreact, some over and some lag off, there is also management manipulation.