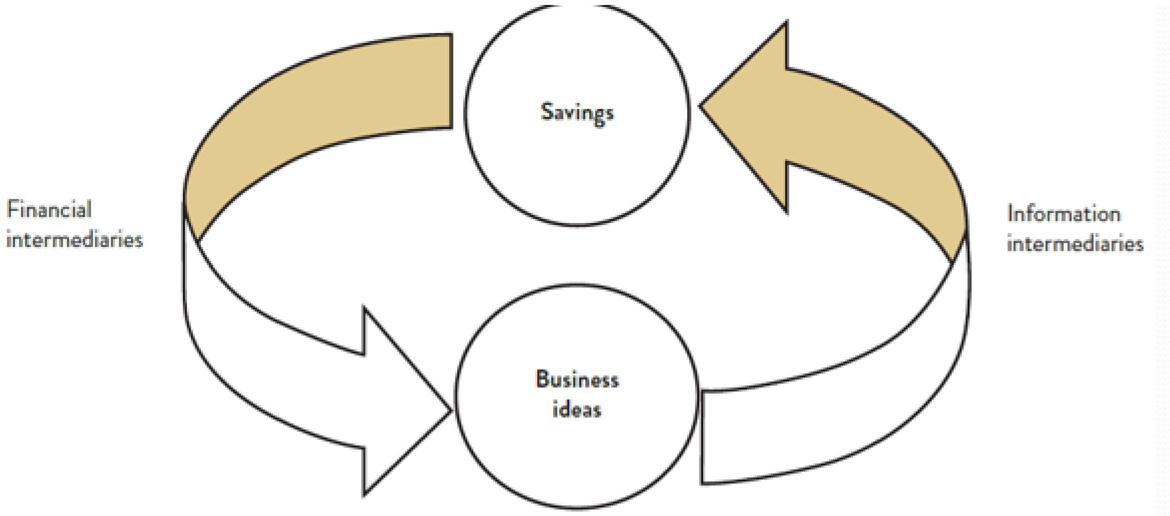
Lecture 1: Introduction

The Role of Financial Reporting in Capital Markets

Financial reporting provides much-needed information to capital market participants.

- Relevant and reliable financial information is essential for the functioning of capital markets.
- Financial intermediaries depend upon the information in financial statements to evaluate investment opportunities.
- Information by entrepreneurs to investors is not completely credible because entrepreneurs have an incentive to inflate the value of their idea.
- Financial intermediaries can assure the quality of financial statement representations.

How Capital Markets Function



Understanding the activities of the firm and value creation

- Critical is the identification of what creates value within the firm.
    - What is the value of the firm?
    - How is value created in the firm?
- Firm value is a function of returns
- A firm creates value when it earns a return greater than the cost of capital

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

From Business Activities to Financial Statements

- Corporate managers acquire physical and financial resources to create value for the firm's investors through business activities.
- Financial statements measure and summarise the economic consequences of business activities.

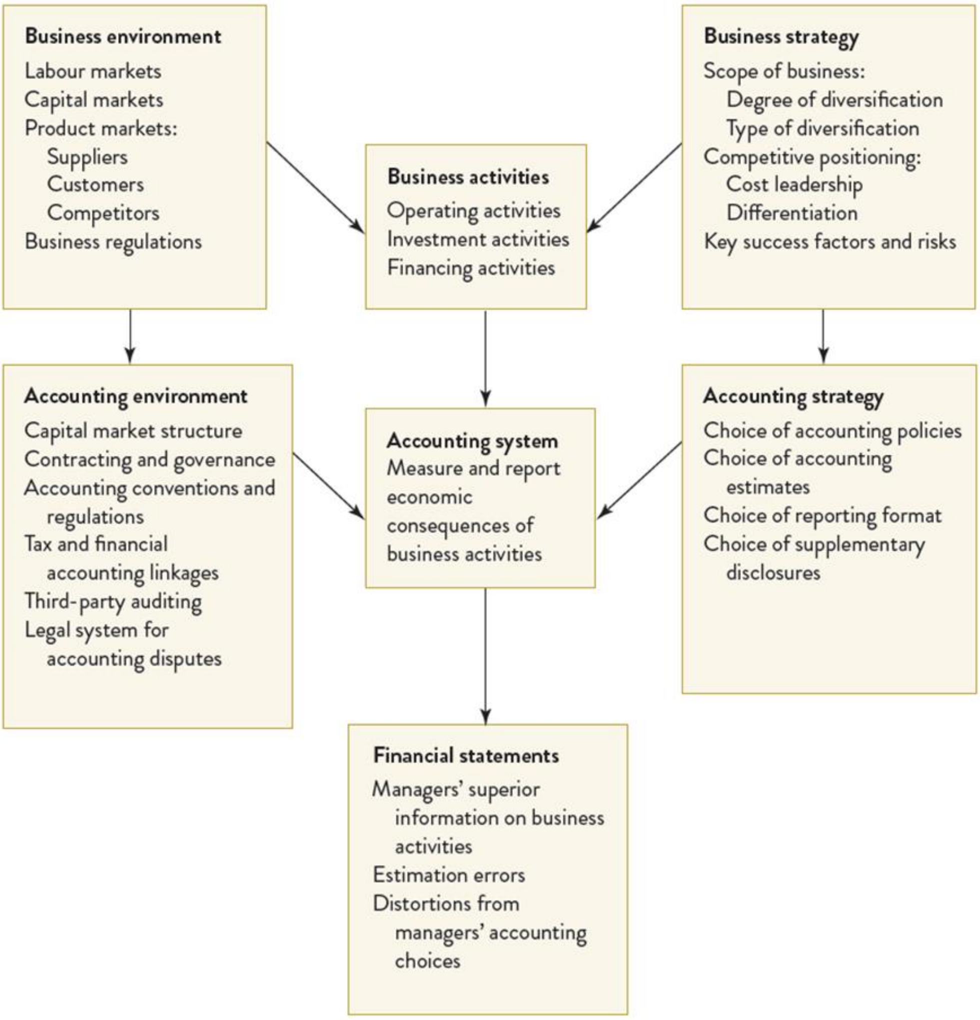


FIGURE 1.2 From business activities to financial statements

Financial statements are a window on the activities of the firm:

- Economic environment
- Business strategies
- Accounting

Good accounting systems facilitate quality information:

- The role of accrual accounting
- Accounting standards or generally accepted accounting principles (GAAP)
- Auditing of financial information
- Managers' reporting strategy.

Accrual accounting

- Need for accrual accounting arises from investors' demand for financial reports on a periodic basis.
- Corporate financial reports prepared using accrual rather than cash accounting.
- Accrual accounting distinguishes between the recording of costs and benefits associated with economic activities.
- Effects of economic transactions are recorded on the basis of expected and not actual cash receipts and payments.

Accounting standards

- Accrual accounting is subjective and relies on a variety of assumptions.
- Managers have incentives to use accounting discretion to distort reported profits.
- Accounting standards are developed to improve the quality of financial reporting.
- Accounting standards ensure that managers are not able to use their accounting flexibility to disguise reality for self-serving purposes.

Managers' reporting strategy

- It is not optimal to use accounting regulation to eliminate managerial flexibility completely.
- Accounting systems leave considerable room for managers to influence financial statement data.
- Corporate managers can choose accounting and disclosure policies to hide the true economic picture of their business and manipulate investors' perceptions.
- Superior disclosure strategy will enable managers to communicate the underlying business reality to outside investors.

Auditing

- Auditing is a verification of the integrity of the reported financial statements by someone independent of the preparer.
- Auditor ensures that managers use accounting rules and conventions consistently over time.
- Auditing improves the quality of accounting data.
- Threat of lawsuits and resulting penalties has the beneficial effect of improving the accuracy of financial information and 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.

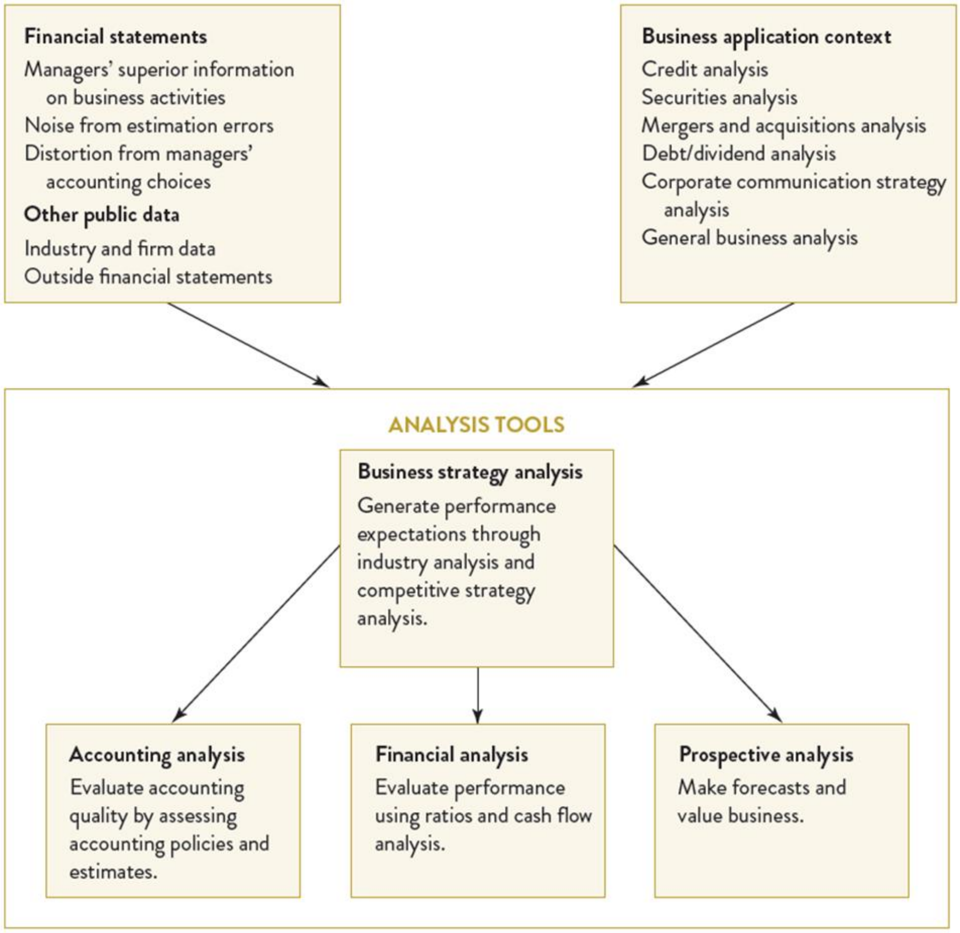
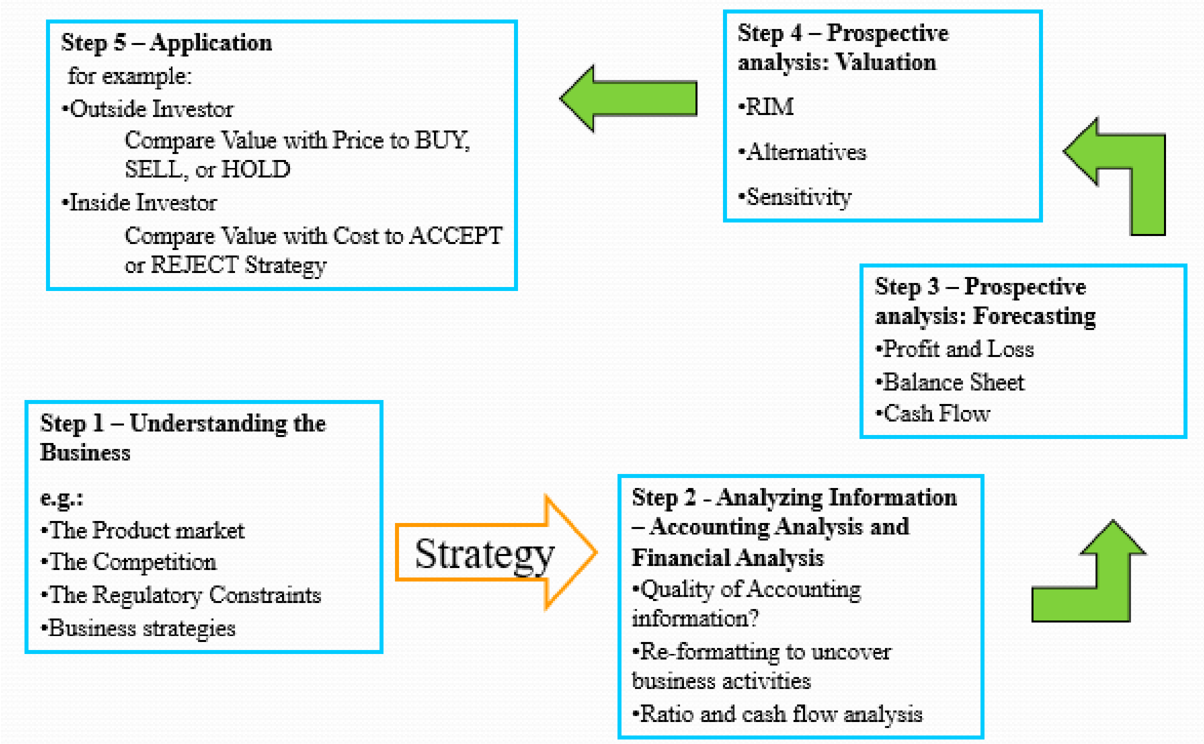


FIGURE 1.3 Analysis using financial statements

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

The steps involved in Business Analysis



Lecture 2: Understanding the Business: Macro Economics, Industry Analysis and Strategy Analysis

Introduction

- Business analysis must start with understanding the economic environment of the business.
- A top-down analysis:
  - Macro-economic factors
  - Industry Analysis
  - Business strategies within the industry

Macro-Economic Analysis

Describe the firm's economic environment and evaluate how this has impacted historic firm performance and is likely relevant to future performance.

- What is the current state and future prospects of the global economy? Individual economies the company operates in?
- Key economic factors:
  - Gross Domestic Product
  - Interest rates
  - Inflation
  - Foreign exchange rates
  - Oil prices / other key commodity prices

Industry-Level Analysis

Evaluate the level of competition in the industry or industries that the firm operates in.

- Analyse each material industry
- Material = > 10% sales revenue

The Importance of Industry-Level Analysis

- A firm's strategy is heavily influenced by the industry it belongs to.
- Understanding the environment and competitive forces within an industry helps with evaluating the quality of a particular firm's strategy and its profitability.
- Porter created a useful framework to evaluate the competitive forces at work in an industry, as seen in Figure 2.1.

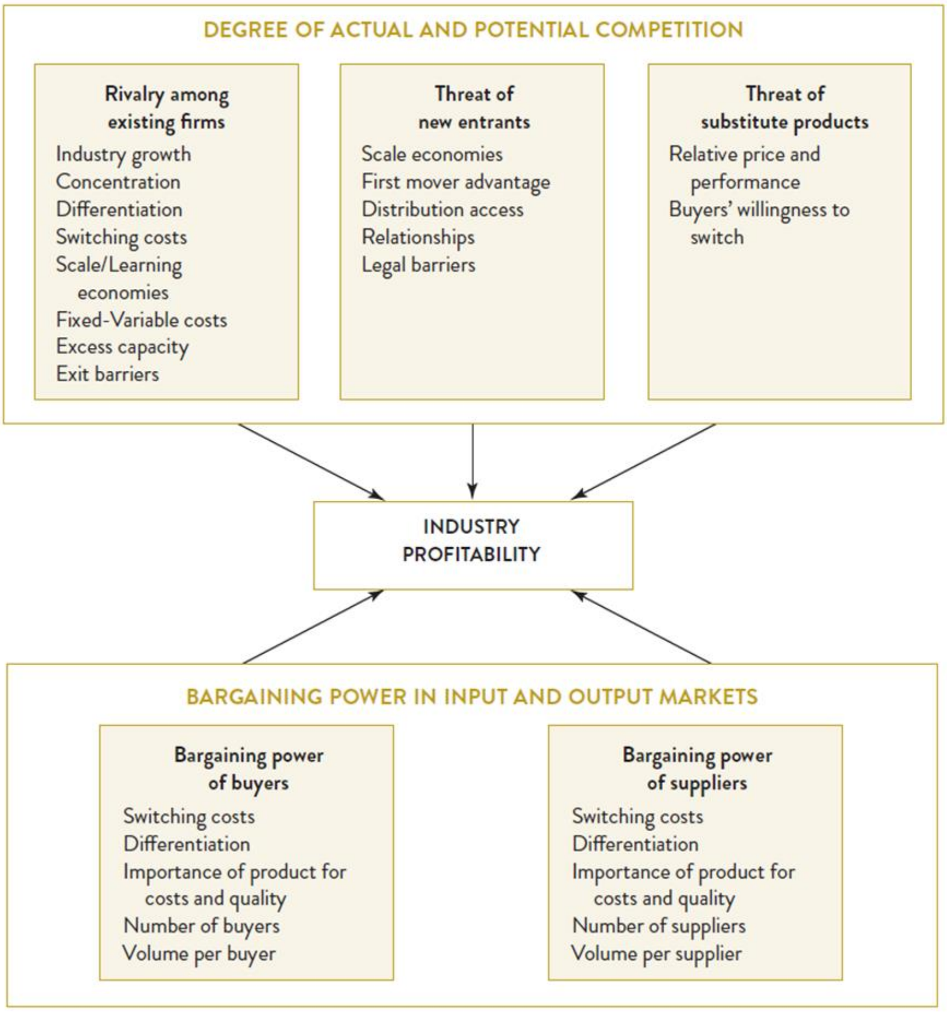


FIGURE 2.1 Industry structure and profitability

Rivalry Among Existing Firms

- Higher degrees of competition among firms:
  - Push prices towards the marginal cost of production
  - Make non-price dimensions of products or services more important.
- Determinants of the intensity of competition among firms:
  - Industry growth rate
  - Concentration and balance of competitors.