Chapter 1: Framework for Business Analysis Using Financial Statements
Key Concepts in Chapter 1

• Financial statements are an important source of information to the capital markets and business analysts.

• Analyzing financial statements addresses a number of issues of interest to external stakeholders and company insiders.
The Role of Financial Reporting in Capital Markets

- Financial reporting provide much needed information to capital market participants
  - Financial intermediaries depend upon the information in financial statements to evaluate investment opportunities.
  - Information intermediaries assure the quality of financial statement representations.
  - Relevant and reliable financial information is essential for the functioning of capital markets.
How Capital Markets Function

![Diagram of capital markets]

- Savings
- Business Ideas
- Financial Intermediaries
- Information Intermediaries
From Business Activities to Financial Statements

• Financial statements measure and summarize the economic consequences of business activities.

• Accounting systems facilitate information quality.
  – The role of accrual basis accounting.
  – The need for generally accepted accounting principles (GAAP).
  – Auditing and the quality of financial information.
From Business Activities to Financial Statements

**Business Environment**
- Labor markets
- Capital markets
- Product markets:
  - Suppliers
  - Customers
  - Competitors
  - Business regulations

**Business Strategy**
- Scope of business:
  - Degree of diversification
  - Type of diversification
- Competitive positioning:
  - Cost leadership
  - Differentiation
- Key success factors and risks

**Business Activities**
- Operating activities
- Investment activities
- Financing activities

**Accounting Environment**
- Capital market structure
- Contracting and governance
- Accounting conventions and regulations
- Tax and financial accounting linkages
- Third-party auditing
- Legal system for accounting disputes

**Accounting System**
- Measure and report economic consequences of business activities.

**Accounting Strategy**
- Choice of accounting policies
- Choice of accounting estimates
- Choice of reporting format
- Choice of supplementary disclosures

**Financial Statements**
- Managers’ superior information on business activities
- Estimation errors
- Distortions from managers’ accounting choices
Financial Statements and Business Analysis

• Business intermediaries use financial statements to accomplish four key objectives:
  – Business strategy analysis
  – Accounting analysis
  – Financial analysis
  – Prospective analysis
Business Strategy Analysis

**Figure 1-3: Analysis Using Financial Statements**

- **Financial Statements**
  - Managers’ superior information on business activities
  - Noise from estimation errors
  - Distortion from managers’ accounting choices
  - Other Public Data
    - Industry and firm data
    - Outside financial statements

- **Business Application Context**
  - Credit analysis
  - Securities analysis
  - Mergers and acquisitions analysis
  - Debt/Dividend analysis
  - Corporate communication strategy analysis
  - General business analysis

**Analysis Tools**

- **Business Strategy Analysis**
  - Generate performance expectations through industry analysis and competitive strategy analysis.

- **Accounting Analysis**
  - Evaluate accounting quality by assessing accounting policies and estimates.

- **Financial Analysis**
  - Evaluate performance using ratios and cash flow analysis.

- **Prospective Analysis**
  - Make forecasts and value business.
Concluding Comments

• Financial statements are source of widely available data on publicly traded corporations.

• Accrual basis accounting attempts to accurately reflect expectations of economic performance, but requires careful analysis.

• This chapter has outlined a useful framework for business analysis using financial statements.