DOWNLOAD PDF FINANCIAL STATEMENT ANALYSIS VALUATION

Chapter 1 : 6 Steps to an Effective Financial Statement Analysis

Financial Statement Analysis & Valuation is intended for use in a financial statement analysis and/or valuation course in which profitability analysis and security valuation are emphasized. This book accommodates miniâ€‘courses lasting only a few days as well as extended courses lasting a full semester.

This article has been updated. For any financial professional, it is important to know how to effectively analyze the financial statements of a firm. This requires an understanding of three key areas: The structure of the financial statements The economic characteristics of the industry in which the firm operates and The strategies the firm pursues to differentiate itself from its competitors. There are generally six steps to developing an effective analysis of financial statements. Identify the industry economic characteristics. Additionally, factors such as supply chain integration, geographic diversification and industry diversification should be considered. Review the key financial statements within the context of the relevant accounting standards. In examining balance sheet accounts, issues such as recognition, valuation and classification are keys to proper evaluation. Analyze current profitability and risk. This is the step where financial professionals can really add value in the evaluation of the firm and its financial statements. With respect to profitability, there are two broad questions to be asked: It is also important to learn how to disaggregate return measures into primary impact factors. Lastly, it is critical to analyze any financial statement ratios in a comparative manner, looking at the current ratios in relation to those from earlier periods or relative to other firms or industry averages. Prepare forecasted financial statements. Although often challenging, financial professionals must make reasonable assumptions about the future of the firm and its industry and determine how these assumptions will impact both the cash flows and the funding. This often takes the form of pro-forma financial statements, based on techniques such as the percent of sales approach. While there are many valuation approaches, the most common is a type of discounted cash flow methodology. These cash flows could be in the form of projected dividends, or more detailed techniques such as free cash flows to either the equity holders or on enterprise basis. Other approaches may include using relative valuation or accounting-based measures such as economic value added. The next steps Once the analysis of the firm and its financial statements are completed, there are further questions that must be answered. One of the most critical is: Whether it is called aggressive accounting, earnings management, or outright fraudulent financial reporting, it is important for the financial professional to understand how these types of manipulations are perpetrated and more importantly, how to detect them. Hands-on examples will cover dashboard and user interaction, data preparation, data summarization and visualization, optimization, forecasting, and automation.

Chapter 2 : Financial Statement Analysis and Valuation

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Magazine Financial Statement Analysis: This process of reviewing the financial statements allows for better economic decision making. Globally, publicly listed companies are required by law to file their financial statements with the relevant authorities. For example, publicly listed firms in America are required to submit their financial statements to the Securities and Exchange Commission SEC. Firms are also obligated to provide their financial statements in the annual report that they share with their stakeholders. As financial statements are prepared in order to meet requirements, the second step in the process is to analyze them effectively so that future profitability and cash flows can be forecasted. Therefore, the main purpose of financial statement analysis is to utilize information about the past performance of the company in order to predict how it will fare in the future. Another important purpose of the analysis of financial statements is to identify potential problem areas and troubleshoot those. These can be classified into internal and external users. Internal users refer to the management of the company who analyzes financial statements in order to make decisions related to the operations of the company. On the other hand, external users do not necessarily belong to the company but still hold some sort of financial interest. These include owners, investors, creditors, government, employees, customers, and the general public. These users are elaborated on below: Management The managers of the company use their financial statement analysis to make intelligent decisions about their performance. For instance, they may gauge cost per distribution channel, or how much cash they have left, from their accounting reports and make decisions from these analysis results. Owners Small business owners need financial information from their operations to determine whether the business is profitable. It helps in making decisions like whether to continue operating the business, whether to improve business strategies or whether to give up on the business altogether. Investors People who have purchased stock or shares in a company need financial information to analyze the way the company is performing. They use financial statement analysis to determine what to do with their investments in the company. So depending on how the company is doing, they will either hold onto their stock, sell it or buy more. Creditors Creditors are interested in knowing if a company will be able to honor its payments as they become due. Government Governing and regulating bodies of the state look at financial statement analysis to determine how the economy is performing in general so they can plan their financial and industrial policies. Employees Employees need to know if their employment is secure and if there is a possibility of a pay raise. Customers Customers need to know about the ability of the company to service its clients into the future. They may wish to evaluate the effects of the firm on the environment, or the economy or even the local community. For instance, if the company is running corporate social responsibility programs for improving the community, the public may want to be aware of the future operations of the company. These are explained below along with the advantages and disadvantages of each method. Horizontal Analysis Horizontal analysis is the comparison of financial information of a company with historical financial information of the same company over a number of reporting periods. It could also be based on the ratios derived from the financial information over the same time span. The main purpose is to see if the numbers are high or low in comparison to past records, which may be used to investigate any causes for concern. For example, certain expenditures that are high currently, but were well under budget in previous years may cause the management to investigate the cause for the rise in costs; it may be due to switching suppliers or using better quality raw material. This method of analysis is simply grouping together all information, sorting them by time period: This analysis is also called dynamic analysis or trend analysis. A disadvantage of horizontal analysis is that the aggregated information expressed in the financial statements may have changed over time and therefore will cause variances to creep up when account balances are compared across periods. Horizontal analysis can also be used to misrepresent results. It can be manipulated to show comparisons across periods which would make the results appear stellar for the company. For instance, if the profits for this month are only compared with those of last month, they may appear outstanding but that may not be the case if compared with the same month the previous year. Using consistent comparison periods can address this problem. Vertical Analysis Vertical analysis is conducted on financial statements for a single time period only. Each item in the statement is shown as a base figure of another item in the statement, for a given time period, usually for year. Typically, this analysis means that every item on an income and loss statement is expressed as a percentage of gross sales, while every item on a balance sheet is expressed as a percentage of total assets held by the firm. Vertical analysis is also called static analysis because it is carried out for a single time period. Advantages and Disadvantages of Vertical Analysis Vertical analysis only requires financial statements for a single reporting period. It is useful for inter-firm or inter-departmental comparisons of performance as one can see relative proportions of account balances, no matter the size of the business or department. Because basic vertical analysis is constricted by using a single time period, it has the disadvantage of losing out on comparison across different time periods to gauge performance. This can be addressed by using it in conjunction with timeline analysis, which shows what changes have occurred in the financial accounts over time, such as a comparative analysis over a three-year period. For instance, if the cost of sales comes out to be only 30 percent of sales each year in the past, but this year the percentage comes out to be 45 percent, it would be a cause for concern. These accounting reports are analyzed in order to aid economic decision-making of a firm and also to predict profitability and cash flows. It is also called the statement of financial position. The two sides of the balance sheet must balance as follows: Current Assets Current assets held by the firm refer to cash and cash equivalents. These cash equivalents are assets that can be easily converted into cash within one year. Current assets include marketable securities, inventory and accounts receivable. Long-term Assets Long-term assets are also called non-current assets and include fixed assets like plant, equipment and machinery, and property, etc. A firm records depreciation of its fixed, long-term assets every year. It is not an actual expense of cash paid, but is only a reduction in the book value of the asset. The book value is calculated by subtracting the accumulated depreciation of prior years from the price of the assets. These include accounts payable, deferred expenses and also notes payable. Long-term Liabilities Long-term liabilities of the firm are financial payments or obligations due after one year. These include loans that the firm has to repay in more than a year, and also capital leases which the firm has to pay for in exchange for using a fixed asset. It is the difference between total assets owned by a firm and total liabilities outstanding. It is different from the market value of equity stock market capitalization which is calculated as follows: Balance Sheet Analysis The balance sheet is analyzed to obtain some key ratios that help explain the health of the firm at a given point in time. These metrics are as follows: It is calculated to assess the leverage, or gearing, of a firm to show how much it relies on debt to finance its activities. This ratio has pertinent implications for the financial health of the firm and the risk and return of its shares. The variations in this ratio also show any value added by the management and its growth prospects. It was previously also called a profit and loss account. The general structure of the income statement with major components is as follows: If the net income is negative, it means the company incurred a loss. Earnings per share can be derived from knowing the total number of shares outstanding of the company: This ratio calculates the amount of profit that the company has earned after taxes and all expenses have been deducted from net sales. This ratio is used to calculate company profit as a percentage of total equity. It assesses whether the stock is overvalued or undervalued. It is essentially a statement whereby the net income is adjusted for non-cash expenses and any changes to the net working capital. It also reflects changes in cash coming from, or being used by, investing and financing activities of the firm. The structure and main components of the cash flow statement are as follows: Cash Flows Statement Analysis In order to measure how much cash is available to the company for investments without outside financing or money diverting from operations, it is useful to conduct a simple cash flow statement analysis. The free cash flow, as the name suggests, allows a company to be able to pay dividends, repay its debts, buy back its stock and also make new investments to facilitate future growth. The excess cash produced by the company, free cash flow, is calculated as follows:

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However, let's explore the "whats" and the "whys" of financial statement analysis and valuation in a little more detail. Types Of Financial Statements There are three types of financial statements issued by CPAs: audits, reviews, and compilations.

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