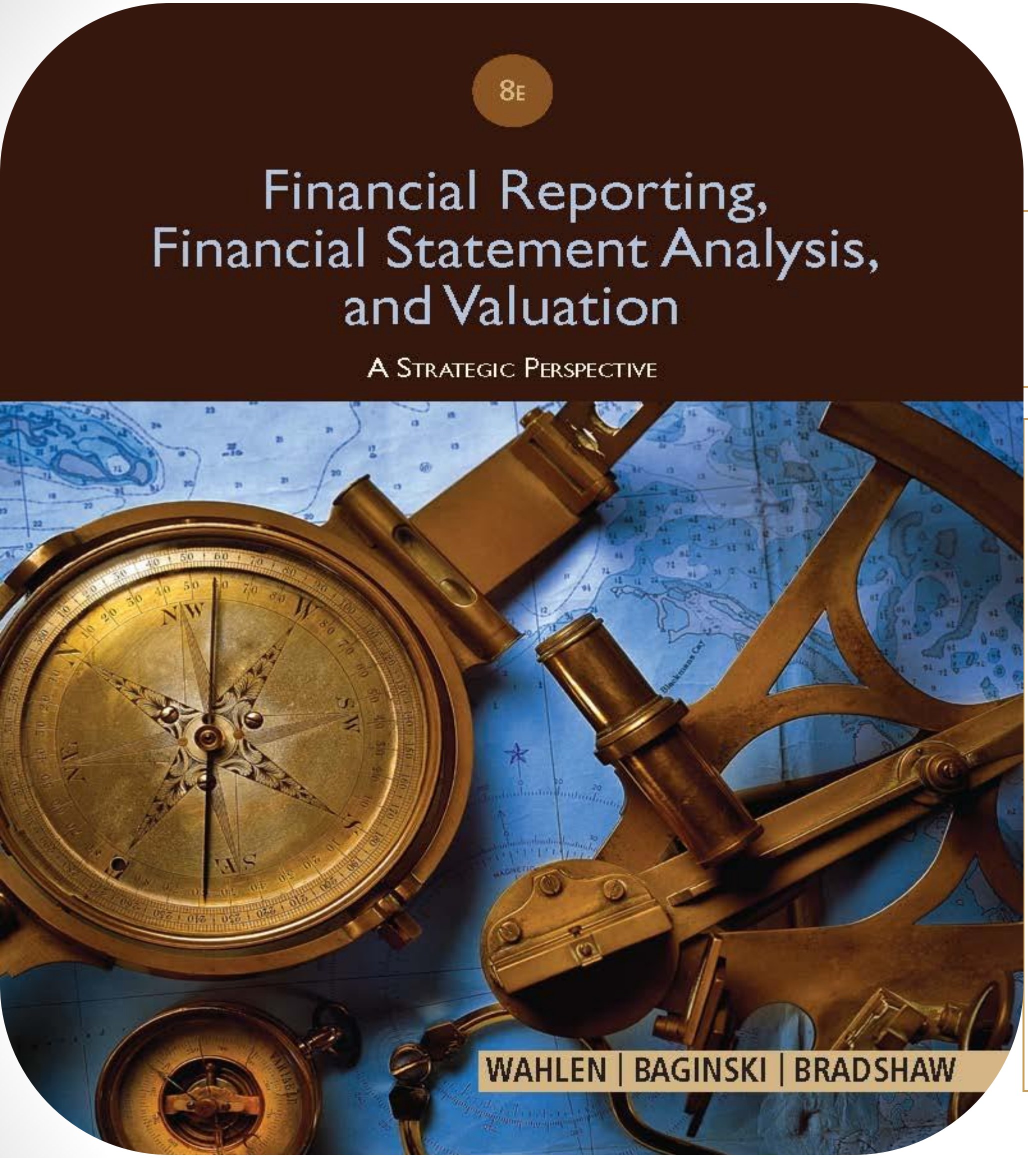


Chapter 1

Overview of Financial Reporting, Financial Statement Analysis, and Valuation

Six-Step Process

Module 1 - Overview of Financial Reporting, Financial Statement Analysis, and Valuation

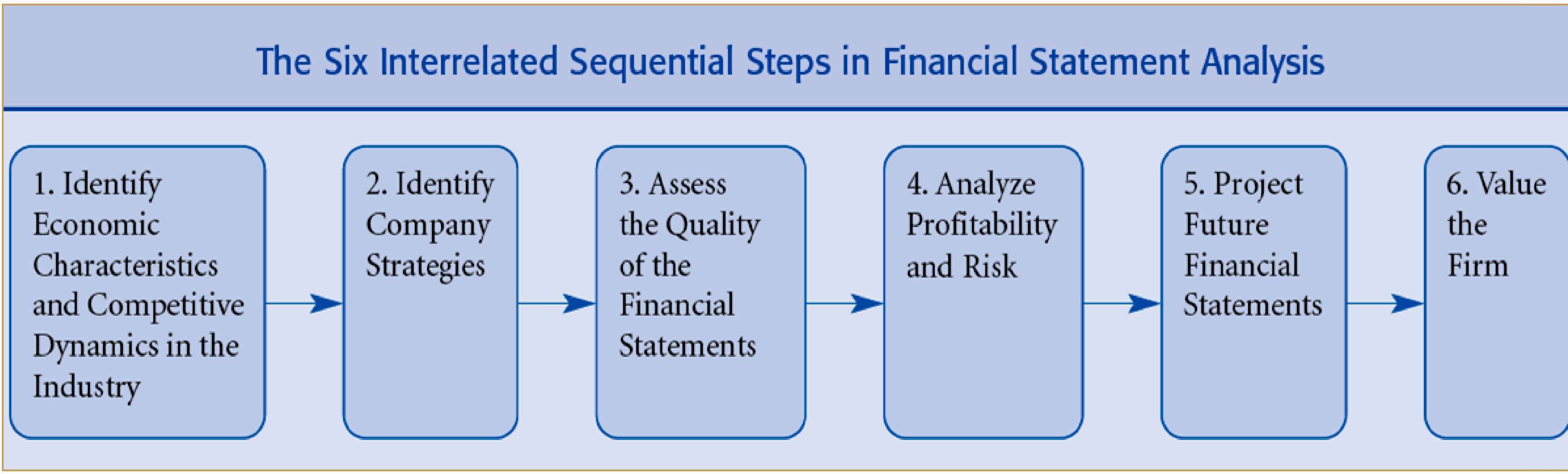
Module 2 - Asset and Liability Valuation and Income Recognition

Module 3 – Financial ratios and Forecasting Financial Statements

Module 4 - Profitability Analysis

Module 5 - Risk Analysis

Six-Step Process



STEP 1: Identify the Industry Economic Characteristics

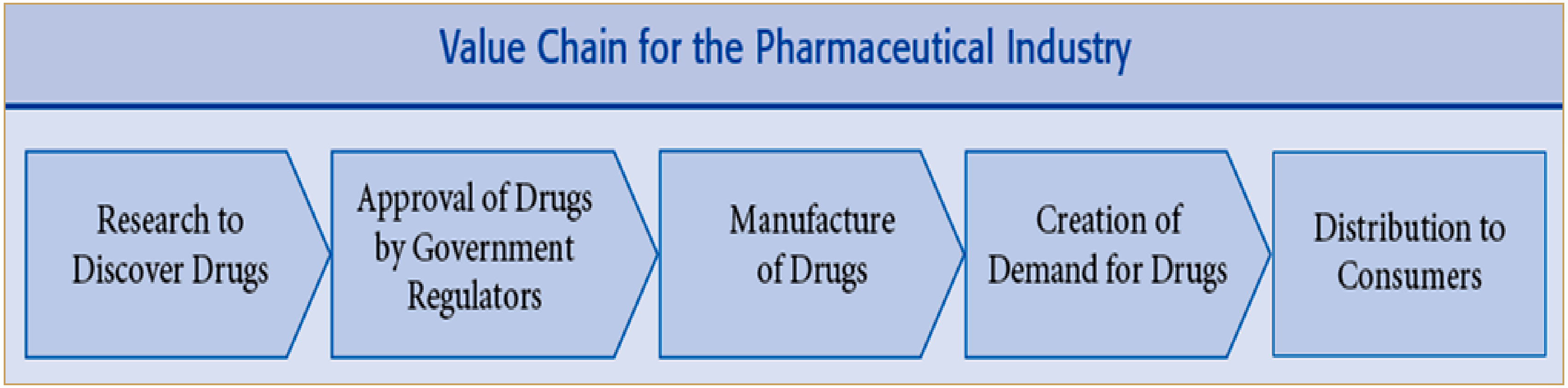
- Economic characteristics and competitive dynamics influences the strategies firms will employ.
- Analyst should consider the economic characteristics and competitive dynamics while analyzing and forecasting financial statements.

STEP 1: Identify the Industry Economic Characteristics

Tools for Studying Industry Economics

- Value chain analysis
- Porter's Five Forces classification framework
- Economic Attributes Framework

Value Chain Analysis



Porter's Five Forces Classification Framework

- Horizontal competition
  - Rivalry (competition) among Existing Firms
  - Threat of New Entrants
  - Threat of Substitutes
- Vertical competition
  - Buyer Power
  - Supplier Power

Rivalry among Existing Firms

- Often the first order of competition.
- Industries are characterized by:
  - Concentrated rivalry.
  - Diffuse rivalry.
- Greater the industry concentration, the lower the competition between existing rivals and thus the more profitable the firms will be.

Threat of New Entrants

- How easily can new firms enter a market?
- Are there entry barriers?
- Do the existing rivals have distinct competitive advantages making it difficult for other firms to enter and compete?
  - If so, firms in the industry will likely generate higher profits than if new entrants can enter the market easily.

Threat of Substitutes

- How easily can customers switch to substitute products or services?
- How likely are they to switch?
- With close substitutes, competition increases and profitability decreases.
- Unique products with few substitutes, enhance profitability.

Buyer Power

- Relates to the relative number of buyers and sellers in the industry and the leverage buyers have with respect to price.
- Relates to buyers' price sensitivity and the elasticity of demand.
- Are the buyers price takers or price setters?

Supplier Power

- Relates to leverage in negotiating input prices from suppliers.
- If an industry has a large number of potential buyers of inputs that are produced by relatively few suppliers, the suppliers will have greater power in setting prices and generating profits.

Economic Attributes Framework

- Demand
- Supply
- Manufacturing
- Marketing
- Investing & Financing

Demand

- Are customers highly price-sensitive or relatively insensitive?
- Is demand growing rapidly or is the industry relatively mature?
- Does demand move with the economic cycle or is it insensitive to it?
- Does demand vary with the seasons or is it relatively stable throughout the year?

Supply

- Are suppliers offering similar or unique products?
- Are there high barriers to entry?
- Are there high barriers to exit, such as environment cleanup costs?

Manufacturing

- Is the manufacturing process capital-intensive or labor-intensive or a combination of the two?
- Is the manufacturing process complex with low tolerance for error or relatively simple with ranges of products that are of acceptable quality?

Marketing

- Is the product promoted to other businesses or marketed directly to consumers?
- Does steady demand pull products through distribution channels, or must firms continually create demand?

Investing and Financing

- Are the assets of firms in the industry relatively short-term or long term?
- Is there relatively little risk or high risk in the assets of firms in the industry?
- Is the industry relatively profitable and mature generating enough cash flows or growing rapidly and in need of external financing?

STEP 2: Identify The Company Strategies

Framework for Strategy Analysis

- Nature of product or service
- Integration within value chain
- Geographical diversification
- Industry diversification

STEP 2: Identify The Company Strategies

- Nature of Product or Service
  - Product differentiation strategy
    - Unique products
    - Achieving relatively high profit margins
  - Low-cost leadership strategy
    - Non-differentiated products
    - Accepting a lower profit margin in return for a higher sales volume and market share

STEP 2: Identify The Company Strategies

- Integration in Value Chain
  - Manufacturing: Is the firm conducting all manufacturing operations itself or outsourcing all manufacturing or outsourcing the manufacturing of components but conducting the assembly operation in-house?
  - Distribution: Is the firm maintaining control over the distribution function or outsourcing it?

STEP 2: Identify The Company Strategies

- Geographical Diversification
  - Is the firm targeting its products to its domestic market or integrating horizontally across many countries?
- Industry Diversification
  - Is the firm operating in a single industry or diversifying across multiple industries?