STEP 3: Assess The Quality Of The Financial Statements

- Income Statement
- Balance Sheet
- Statement of Cash Flows
- Statement of Shareholders' Equity
- Statement of Comprehensive Income

First four statements are required; most companies include all five.

Accounting Principles

- GAAP determines the valuation and measurement methods used in preparing financial statements.
- SEC has the legal authority to specify acceptable accounting principles in the United States but, has delegated that authority to the FASB

STEP 3: Assess The Quality Of The Financial Statements

- Balance Sheet or Statement of financial position.

  Assets = Liabilities + Shareholders' Equity

  - Assets portion of the balance sheet reports the effects of a firm's operating decisions and investing decisions.
  - Liabilities and shareholders' equity portion of the balance sheet reports obligations that arise from a firm's operating decisions and financing decisions.

STEP 3: Assess The Quality Of The Financial Statements

- Assets
  - A firm can recognize as assets only those resources:
    1. for which it has the rights to future economic benefits as a result of a past transaction or event.
    2. for which the firm can predict and measure, the future benefits with a reasonable degree of precision and reliability.
  - Categorized into Current Assets, Investments, Property, Plant, and Equipment and Intangibles.

STEP 3: Assess The Quality Of The Financial Statements

- Liabilities
  - Reflect managers' expectations of future sacrifices of resources to satisfy existing obligations.
  - Categorized into:
    - Current liabilities : includes obligations a firm expects to settle within one year.
    - Noncurrent liabilities: includes long-term debt obligations, other liabilities, and deferred income taxes.

STEP 3: Assess The Quality Of The Financial Statements

- Shareholders’ Equity
  - Firms residual interest or claim.
- It includes:
  - Amounts initially contributed by shareholders for an interest in a firm.
  - Cumulative net income in excess of dividends declared.
  - Shareholders' equity effects the recognition or valuation of certain assets or liabilities.
  - Treasury stock.

Assessing the Quality of the Balance Sheet as a Complete Representation of Economic Position

- Analyst recognizes:
  - Resources of a firm that generate future cash flows appear as assets only if they were acquired from another firm and have a measurable acquisition cost.
  - Nonmonetary assets are reported at acquisition cost, net of accumulated depreciation or amortization.

Assessing the Quality of the Balance Sheet as a Complete Representation of Economic Position

- Analyst recognizes: (Contd.)
  - Rights to use resources and commitments to make future payments may not appear as assets and liabilities.
  - Noncurrent liabilities appear at the present value of expected cash flows discounted at an interest rate prevailing when the liability initially arose.

STEP 3: Assess The Quality Of The Financial Statements

- Income Statement - Measuring Operating Performance
  - Provides information about the profitability of a firm for a period of time.
  - Under accrual basis of accounting, revenue when is recognized when:
    - It has completed all (or substantially all) of the revenue-generating process by delivering products or services to customers.
    - It is reasonably certain it has satisfied a liability or generated an asset that it can measure reliably.

STEP 3: Assess The Quality Of The Financial Statements

- Statement Of Cash Flows
  - Assesses a firm's past ability to generate free cash flows and for predicting future free cash flows.
  - Categories:
    - Operating
    - Investing
    - Financing

Transactions not directly involving cash are disclosed either in a supplementary schedule or in a note to the statement of cash flows.

STEP 4: Analyze Profitability and Risk

- Tools:
  - Common-size financial statements
  - Percentage change financial statements
  - Financial Statement Ratios
    - Profitability: EPS, ROCE etc.
    - Risk: Current Ratio, Debt to Equity Ratio etc.

STEP 5: Prepare Forecasted Financial Statements

- Forecasts are the inputs into valuation models and the quality of the decisions rests on the reliability of the forecasts.
- Forecasted financial statements rely on assumptions the analyst makes about the future.
- Amounts from the forecasted financial statements serve as the basis for the valuation models.

STEP 6: Value the Firm

- Approaches:
  - Dividends
  - Earnings
  - Cash flows
  - Market

  First three methods will give same value.

Role Of Financial Statement Analysis In An Efficient Capital Market

- Benefits:
  - Stock market prices react with a high degree of efficiency to published information about a firm.
  - An implication of highly efficient capital market is that analysts and investors have more difficulty finding undervalued or overvalued securities.