BUSINESS ANALYSIS & VALUATION

USING FINANCIAL STATEMENTS

5e

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PREFACE

Financial statements are the basis for a wide range of business analysis. Managers use them to monitor and judge their firms' performance relative to competitors, to communicate with external investors, to help judge what financial policies they should pursue, and to evaluate potential new businesses to acquire as part of their investment strategy. Securities analysts use financial statements to rate and value companies they recommend to clients. Bankers use them in deciding whether to extend a loan to a client and to determine the terms of the loan. Investment bankers use them as a basis for valuing and analyzing prospective buyouts, mergers, and acquisitions. And consultants use them as a basis for competitive analysis for their clients.

Not surprisingly, therefore, we find that there is a strong demand among business students for a course that provides a framework for using financial statement data in a variety of business analysis and valuation contexts. The purpose of this book is to provide such a framework for business students and practitioners. The first four editions of this book have succeeded far beyond our expectations in equipping readers with this useful framework, and the book has gained proponents in accounting and finance departments in business schools in the United States and around the world.

CHANGES FROM THE FOURTH EDITION

In response to suggestions and comments from colleagues, students, and reviewers, we have incorporated the following changes in the fifth edition:

- Data, analyses, and issues have been thoroughly updated.
- Where appropriate, lessons have been drawn from current events such as the global financial crisis of 2008 and the ongoing European debt crisis.
- The financial analysis and valuation chapters (Chapters 6–8) have been updated with a focus on firms in the U.S. retail department store sector, primarily TJX and Nordstrom. In addition, we have provided a more cohesive overall discussion of the four key components of effective financial statement analysis that this book examines by introducing these companies in our discussion of strategy analysis in Chapter 2 and staying with them through the accounting, financial, and prospective analyses that follow.
- We have provided a greatly expanded examination of the impact of accounting adjustments (introduced in Chapter 4) on company analysis by analyzing both unadjusted and adjusted financial ratio and cash flow measures for TJX and Nordstrom in Chapter 5, and by then using adjusted numbers for TJX in the prospective analysis of Chapters 6–8.
- The topic of U.S. GAAP/IFRS convergence is introduced and examined, with discussion and examples in comparing companies reporting under U.S. GAAP and IFRS, and a brief discussion on important remaining differences between U.S. GAAP and IFRS.
- An expanded discussion of fair value accounting is included, given its increasing use globally and also its much discussed role in the 2008 financial crisis.
- We have streamlined and greatly enhanced the readability of the discussion on the theory behind valuation techniques in Chapters 7 and 8.
- In our Text and Cases edition, we have included new and updated Harvard Business School cases. In all, we include 27 cases in this edition.

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- We are introducing with this edition an online version of the BAV modeling tool, which represents a significant enhancement of the tool over the previous spreadsheet-based version. This comprehensive modeling tool implements the analytical framework and techniques discussed in this book, and allows students to easily import the financial statements of a company into the model from three major data providers—Thomson ONE, Capital IQ, and the Compustat database of the Wharton Research Data Services—as well as to import manually created statements. A user-friendly interface allows the analyst to navigate through the tool with ease. The tool facilitates the following activities: (1) recasting the reported financial statements in a standard format for analysis; (2) performing accounting analysis as discussed in Chapters 3 and 4, making desired accounting adjustments, and producing restated financials; (3) computing ratios and free cash flows as presented in Chapter 5; (4) producing forecasted income, balance sheet, and cash flow statements for as many as 15 years into the future using the approach discussed in Chapter 6; (5) preparing a terminal value forecast using the abnormal earnings, the abnormal returns, and discounted cash flow methods as discussed in Chapters 7 and 8; and (6) valuing a company (either assets or equity) from these forecasts as also discussed in Chapters 7 and 8. We have seen that the BAV modeling tool can make it significantly easier for students to apply the framework and techniques discussed in the book in a real-world context, and we feel that the new online version, with its enhanced data import flexibility and improved overall interface, further enhances the usability and usefulness of this tool.

KEY FEATURES

This book differs from other texts in business and financial analysis in a number of important ways. We introduce and develop a **four-part framework for business analysis and valuation** using financial statement data. We then show how this framework can be applied to a variety of decision contexts.

Framework for Analysis

We begin the book with a discussion of the role of accounting information and intermediaries in the economy, and how financial analysis can create value in well-functioning markets (Chapter 1). We identify four key components, or steps, of effective financial statement analysis:

- Business strategy analysis
- Accounting analysis
- Financial analysis
- Prospective analysis

The first step, **business strategy analysis** (Chapter 2), involves developing an understanding of the business and competitive strategy of the firm being analyzed. Incorporating business strategy into financial statement analysis is one of the distinctive features of this book. Traditionally, this step has been ignored by other financial statement analysis books. However, we believe that it is critical to begin financial statement analysis with a company's strategy because it provides an important foundation for the subsequent analysis. The strategy analysis section discusses contemporary tools for analyzing a company's industry, its competitive position and sustainability within an industry, and the company's corporate strategy.

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Accounting analysis (Chapters 3 and 4) involves examining how accounting rules and conventions represent a firm's business economics and strategy in its financial statements, and, if necessary, developing adjusted accounting measures of performance. In the accounting analysis section, we do not emphasize accounting rules. Instead we develop general approaches to analyzing assets, liabilities, entities, revenues, and expenses. We believe that such an approach enables students to effectively evaluate a company's accounting choices and accrual estimates, even if they have only a basic knowledge of accounting rules and standards. The material is also designed to allow students to make accounting adjustments rather than merely identify questionable accounting practices.

Financial analysis (Chapter 5) involves analyzing financial ratio and cash flow measures of the operating, financing, and investing performance of a company relative to either key competitors or historical performance. Our distinctive approach focuses on using financial analysis to evaluate the effectiveness of a company's strategy and to make sound financial forecasts.

Finally, in **prospective analysis** (Chapters 6–8) we show how to develop forecasted financial statements and how to use these to make estimates of a firm's value. Our discussion of valuation includes traditional discounted cash flow models as well as techniques that link value directly to accounting numbers. In discussing accounting-based valuation models, we integrate the latest academic research with traditional approaches such as earnings and book value multiples that are widely used in practice.

Although we cover all four steps of business analysis and valuation in the book, we recognize that the extent of their use depends on the user's decision context. For example, bankers are likely to use business strategy analysis, accounting analysis, financial analysis, and the forecasting portion of prospective analysis. They are less likely to be interested in formally valuing a prospective client.

Application of the Framework to Decision Contexts

The next section of the book shows how our business analysis and valuation framework can be applied to a variety of decision contexts:

- Equity securities analysis (Chapter 9)
- Credit analysis and distress prediction (Chapter 10)
- Merger and acquisition analysis (Chapter 11)
- Communication and governance (Chapter 12)

For each of these topics we present an overview to provide a foundation for the class discussions. Where possible we bring in relevant real-world scenarios and institutional details, and also examine the results of academic research that are useful in applying the analysis concepts developed earlier in the book. For example, the chapter on credit analysis shows how banks and rating agencies use financial statement data to develop analyses for lending decisions and to rate public debt issues. This chapter also presents academic research on how to determine whether a company is financially distressed.

USING THE BOOK

We designed the book so that it is flexible for courses in financial statement analysis for a variety of student audiences—MBA students, master's in accounting students, executive program participants, and undergraduates in accounting or finance. Depending upon the audience, the instructor can vary the manner in which the conceptual materials in the chapters and end-of-chapter questions are used. To get the most out of the book,

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students should have completed basic courses in financial accounting, finance, and either business strategy or business economics. The text provides a concise overview of some of these topics. But it would probably be difficult for students with no prior knowledge in these fields to use the chapters as stand-alone coverage of them.

If the book is used for students with prior working experience or for executives, the instructor can use almost a pure case approach, adding relevant lecture sections as needed. When teaching students with little work experience, a lecture class can be presented first, followed by an appropriate case or other assignment material. Alternatively, lectures can be used as a follow-up to cases to more clearly lay out the conceptual issues raised in the case discussions. This may be appropriate when the book is used in undergraduate capstone courses. In such a context, cases can be used in course projects that can be assigned to student teams.

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Professor Healy's research includes studies of the performance of financial analysts, corporate governance, the performance of mergers, corporate disclosure, and managers' financial reporting decisions. His work has been published in leading journals in accounting and finance. In 1990, his article "The Effect of Bonus Schemes on Accounting Decisions," published in *Journal of Accounting and Economics*, was awarded the AICPA/AAA Notable Contribution Award. His text *Business Analysis and Valuation* was awarded the AICPA/AAA's Wildman Medal for contributions to the practice in 1997, and the AICPA/AAA Notable Contribution Award in 1998.

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