ACCT13017 *Financial Statement Analysis*

FINANCIAL STATEMENT ANALYSIS

To Know What Adds Value

Martin Turner

PREFACE

> Relying too heavily on other people's opinions can damage our sense of reality.
>
> Derek Rowntree[1]

Prior to the late 19th century, a firm's financial statements were usually very much only for the eyes of those within a firm. They were generally private to a firm; not something appropriate for public discussion. Over the past 100 years or so this has been progressively changing. Those providing debt to firms increasingly found they had the power to require firms to disclose various financial information. With the increasing separation of management of firms from ownership of firms, there has been an increasing need for equity investors to be given financial information. Where they lacked the power to require firms to provide it to them, various regulatory rules have been developed to require firms to provide increasing amounts of information to the public in their financial statements. Firms' business activities affect many more people than debt and equity providers to a firm. Employees, customers, suppliers, competitors, regulators, taxation authorities and the general community all have a genuine interest in analysing the financial statements of firms. A firm's financial statements have become increasingly of interest to a wide range of people.

As financial statements of firms have become increasingly available for scrutiny by those outside of firms, people have had to figure out what to do with them; how best to use the information in a firm's financial statements. This Study Guide incorporates some of the ideas and 'good thinking' of many people who have been grappling with this issue. It owes much to the thinking of Benjamin Graham and David Dodd in their classic book, *Security Analysis*[2] and of Benjamin Graham in *The Intelligent Investor*[3]; and to the more recent excellent thinking of James Ohlson, Stephen Penman and many others.[4] Also, this Study Guide focuses our attention on business reality, not on the financial statements themselves. Our focus will not be simply on analysing and understanding a firm's financial statements. Rather, it will be on using financial statements, along with other information, to help us engage with the economic and business realities of firms. There is a real world of business with which we want to engage; we will have the opportunity to see how financial statement analysis can help us do this.

We will emphasise the importance of conducting fundamental analysis on firms ourselves. We see that relying too heavily on other people's opinions can damage our sense of reality. In all aspects of life we need to develop our own sense of reality. It is no different in business. It is no different in investing and in the capital markets. It is very easy for our analysis of financial statements in practice to be disconnected from any coherent theory or view of what adds value in business. Without some shared ideas and concepts of value to help capital markets stay closely connected to reality, our capital markets can be vulnerable to periods of quite wide fluctuations and misallocation of capital. We will focus on deeply understanding what adds value to equity investors of firms. A deep understanding of this, in the context of an awareness of the genuine interests of a range of other stakeholders, is central to this Study Guide and to our study of financial statement analysis in our unit. Also central is the need for us to connect our practice of financial statement analysis to a coherent theory, framework or way of thinking. We will see that the future earnings capacity of a firm drives both a firm's expected future cash flow and its economic profit. Also, we will make practical the discounted cash flow (DCF) and economic profit approaches to valuation as a guide to helping us understand investment value; and the value and importance of thorough and intelligent fundamental analysis of firms.

You may, or may not, agree with everything in this Study Guide. It brings together a lot of 'good thinking' about financial statement analysis from many people; and the thinking underpinning these ideas are challenging. I look forward to us exploring these ideas together. This capstone unit, ACCT13017 *Financial Statement Analysis*, will draw on what you have learnt from all the units you have studied in your Bachelor of Accounting or Accounting major. This involves accounting, finance, marketing, management, economics, law and tax. This will give you the chance to review what you have learnt (and perhaps identify what you have not learnt) in your previous units and to deepen and strengthen your understanding of the concepts you studied in these units. As you do this, you will have the opportunity to discover, and strengthen your understanding about, the links that exist between these concepts, as we study financial statement analysis together and explore how accounting can help us to 'know what adds value' in a business.

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FOOTNOTES

1. Rowntree, D., *Assessing Students: How Shall We Know Them?* Kogan Page. London. Rev. ed. 1987.
2. Graham, B. and Dodd, D.L., *Security Analysis: Principles and Techniques*, McGraw-Hill Book Company, Inc. New York & London. Second Edition. 1940.
3. Graham B., *The Intelligent Investor*, New York: Harper and Row, 4th rev. ed., 1973: 315.
4. Professor James Ohlson is Professor of Accounting at the New York University Stern School of Business. His research has focused on accounting theory and the role of accounting data in equity valuation contexts. Professor Stephen Penman is the George O. May Professor of Accounting, Graduate School of Business, Columbia University. His research focuses on financial statement analysis and the use of accounting information in equity valuation.