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FINANCE AND INFORMATION MANAGEMENT/ INFORMATION TECHNOLOGY

PT SIMELANE

FRAMEWORK FOR BUSINESS ANALYSIS AND VALUATION USING FINANCIAL STATEMENTS (CHAPTER I)

KEY CONCEPTS

- **Financial statements** are an important source of information to the capital markets and business analysts.
- Analyzing financial statements addresses a number of issues of interest to external stakeholders and company insiders.

CAPITAL MARKETS

- **Capital markets** are where savings and investments are channeled between suppliers and those in need.
- Suppliers are people or institutions with capital to lend or invest and typically include banks and investors. Those who seek capital in this market are businesses, governments, and individuals.
- Capital markets are composed of **primary and secondary markets**. The most common capital markets are the **stock market and the bond market**. They seek to improve transactional efficiencies by bringing suppliers together with those seeking capital and providing a place where they can exchange securities.

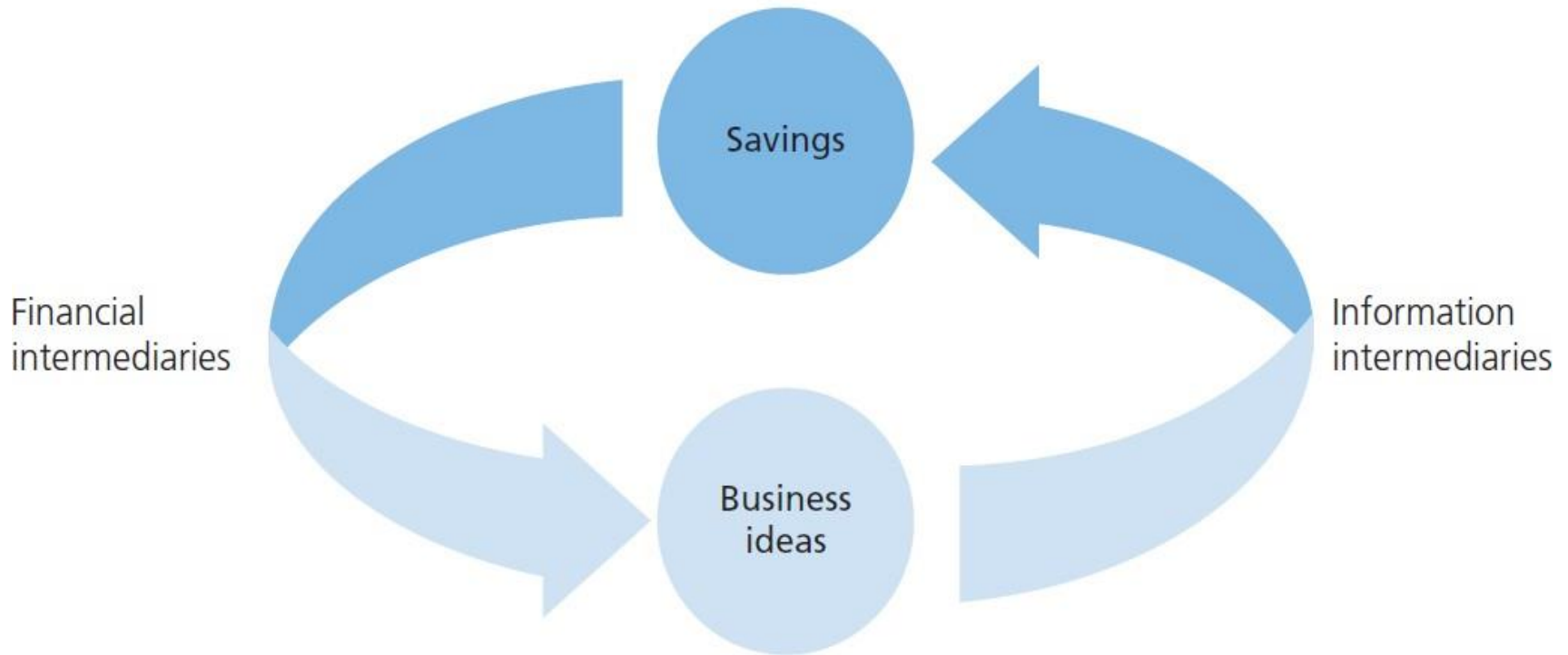
THE ROLE OF FINANCIAL REPORTING IN CAPITAL MARKETS

- Financial reporting provides much-needed information to capital market participants
 - Financial intermediaries depend upon the information in financial statements to evaluate investment opportunities.
 - Information intermediaries assure the quality of financial statement representations.
 - Relevant and reliable financial information is essential for the functioning of capital markets.

HOW CAPITAL MARKETS FUNCTION



FIGURE 1.1 Capital markets



FROM BUSINESS ACTIVITIES TO FINANCIAL STATEMENTS

- Financial statements measure and summarize the economic consequences of business activities.
- **Accounting system** is a system used to track and organize all the financial information for a business such as income, expenses, sales, inventory, taxes, payroll, and compile financial reports.
- **Types of Account system**
 - Manual accounting systems (pen & paper or spreadsheets)
 - Automated cloud accounting systems (online accounting software)
 - ERP software.
- The different types of accounting systems are single-entry bookkeeping and double-entry bookkeeping.
- The different accounting methods are cash-based accounting and accrual-based accounting.

FROM BUSINESS ACTIVITIES TO FINANCIAL STATEMENTS

- Accounting systems facilitate information quality.
 - The role of accrual accounting.
 - The need for accounting conventions and standards.
 - Managers' accounting choices and strategies.
 - Auditing and the quality of financial information.



Accruals

[ə-'krü-əls]

A method of accounting in which revenues and expenses are recorded as they are incurred.


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graph TD; BE[Business environment] --> AS[Accounting system]; AE[Accounting environment] --> AS; BS[Business strategy] --> AS; AStr[Accounting strategy] --> AS; BA[Business activities] --> AS; AS --> FS[Financial statements];
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Business environment
Labor markets
Capital markets
Product markets:
Suppliers
Customers
Competitors
Business regulations

Business activities
Operating activities
Investment activities
Financing activities

Business strategy
Scope of business:
Degree of diversification
Type of diversification
Competitive positioning:
Cost leadership
Differentiation
Key success factors and risks

Accounting environment
Capital market structure
Contracting and governance
Accounting conventions and regulations
Tax and financial accounting linkages
Third-party auditing
Legal system for accounting disputes

Accounting system
Measure and report economic consequences of business activities

Accounting strategy
Choice of accounting policies
Choice of accounting estimates
Choice of reporting format
Choice of supplementary disclosures

Financial statements
Managers' superior information on business activities
Estimation errors
Distortions from managers' accounting choices

ACCRUAL ACCOUNTING

- Financial reports are prepared using accrual accounting instead of cash accounting.
- IFRS defines the following financial statement elements:
 - Assets
 - Liabilities
 - Equity
 - Income or Revenue
 - Expenses
 - Profit or Loss

MANAGEMENT'S RESPONSIBILITY FOR REPORTING FINANCIAL INFORMATION

- Applying accounting principles is the responsibility of management, who has superior knowledge of a firm's business.
- Incentives exist for management to distort accounting numbers in their favour.
 - Contracts
 - Reputation
- Mitigating effects of legal liability, auditing, public enforcement.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

- The EU and other countries worldwide have relied on the IASB to set accounting standards (IFRS); many countries have endorsement procedures.
- IFRS allows for consistency in reporting between firms and over different time periods of the same firm.
- Uniform accounting standards minimize manager's ability to manipulate financial statement information.
- Rigid accounting rules may be dysfunctional; calls for principles-based accounting standards.

EXTERNAL AUDITING OF FINANCIAL STATEMENTS

- Required for publicly traded companies; within the EU also required for some private firms.
- Conducted according to standards:
 - EU: minimum standards set by the Revised Statutory Audit Directive and Regulation (US: Sarbanes-Oxley Act)
 - International Standards of Auditing (US: GAAS)
- Auditing has its limitations; it is backed up by legal liability and public enforcement.

PUBLIC ENFORCEMENT

- Most countries have public enforcement bodies to review compliance and take actions to correct noncompliance.
- Public enforcement cannot ensure full compliance because enforcement bodies work:
 - Proactively on a sampling basis or
 - On a complaint basis
- There is international diversity in enforcement quality; the ESMA (European Securities and Markets Authority) coordinates enforcement activities in the EU

FACTORS INFLUENCING ACCOUNTING QUALITY

- It is necessary to allow managers some discretion in applying accounting standards.
- As a result, three potential sources of noise and bias in accounting data include:
 1. Noise from accounting rules
 2. Forecast errors
 3. Manager's accounting choices

NOISE FROM ACCOUNTING RULES AND FORECAST ERRORS

- The fit between accounting standards and the nature of the firm's transactions may introduce some distortion in the reported financial statements.
- Management's estimates may result in accounting forecasting errors reflected in the financial statements.

ALTERNATE FORMS OF INVESTOR COMMUNICATION

- Analyst meetings
 - Regular meetings with analysts releases information to these intermediaries.
 - Material information released to analysts must also be publicly disclosed.
- Voluntary disclosure
 - Management has the discretion to voluntarily disclose information, though there are constraints on this type of disclosure.

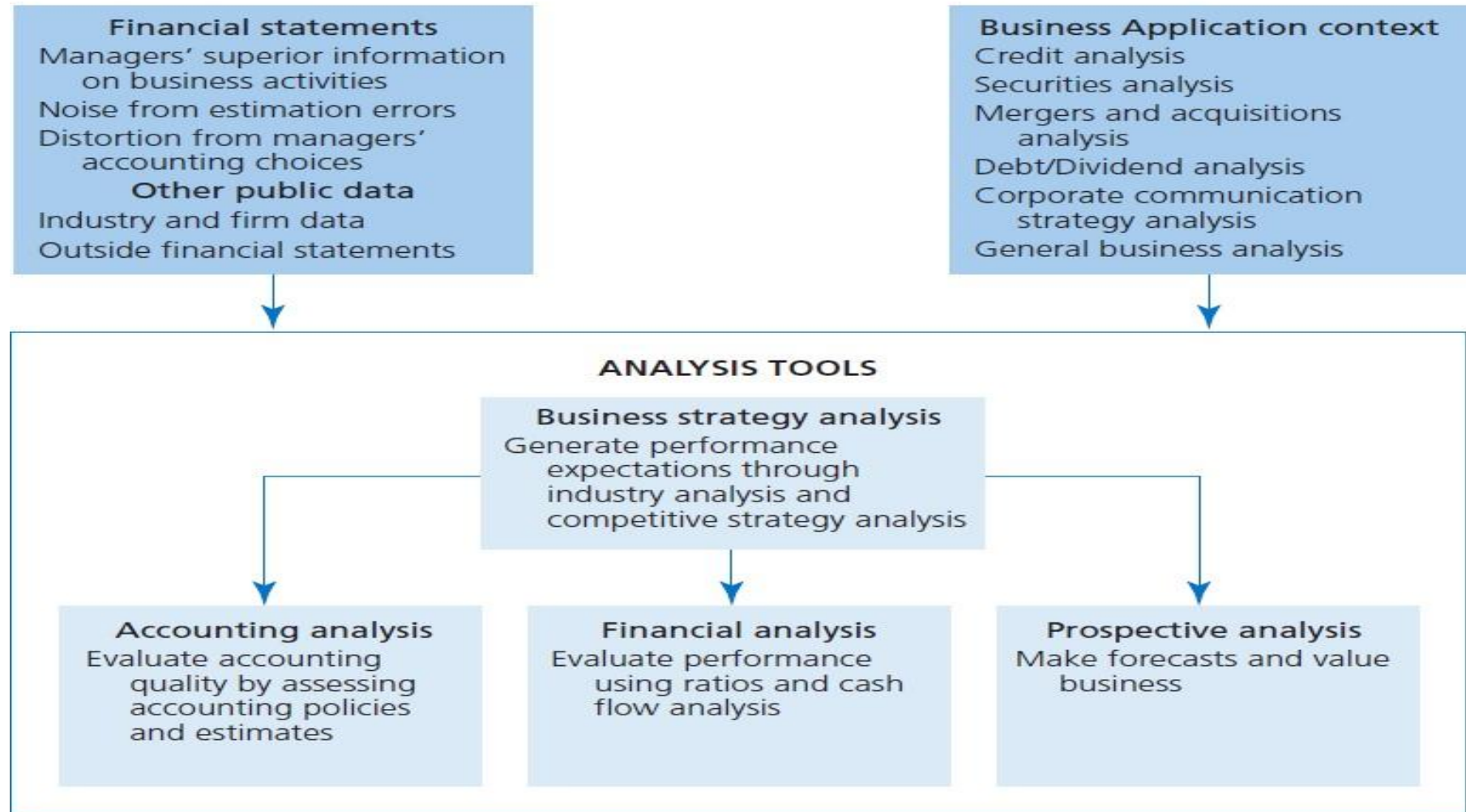
FINANCIAL STATEMENTS AND BUSINESS ANALYSIS

- Business intermediaries use financial statements to accomplish four key objectives:
 - Business strategy analysis
 - Accounting analysis
 - Financial analysis
 - Prospective analysis

BUSINESS STRATEGY ANALYSIS



FIGURE 1.3 Analysis using financial statements



CONCLUDING COMMENTS

- Financial statements are a source of widely available data on publicly traded corporations.
- Accrual accounting attempts to accurately reflect expectations of economic performance but requires careful analysis.
- This chapter has outlined a useful framework for business analysis using financial statements.

THANK
YOU

