

ACCT7106 – Session #6: Reformulating the Financial Statements

PART 1 – Background

- overarching objective:* **Assignment Project Exam Help**
to conduct fundamental valuation of a firm's common shares, estimating the 'intrinsic value' of
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- requires an understanding of the firm's value
 - ➔ need to accumulate a 'tool kit' as the basis for developing the *pro forma Financial Statements*

⇒ **projected** {
over the forecast horizon {
Balance Sheet (B/S)
Income Statement (I/S)
Statement of Cash Flows (SCF) }

➡ core inputs ➡ x g
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Sessions #3 → #9



STEP 1
Understanding the past

1. Information collection
2. Understanding the business
3. Accounting analysis
4. Financial ratio analysis
5. Cash flow analysis

STEP 2
Forecasting the future

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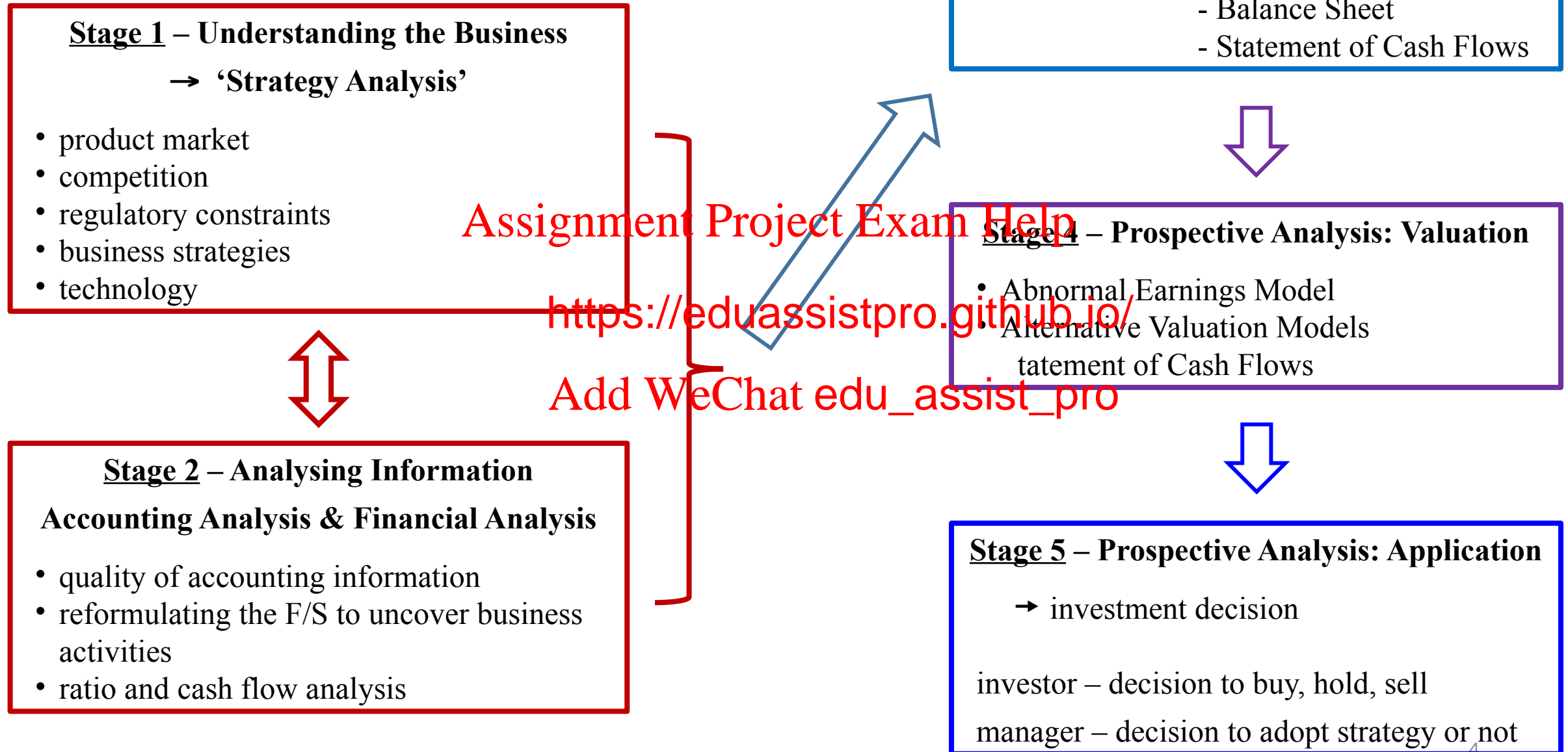
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STEP 3
Valuation

1. Cost of capital
2. Valuation models – AE, FCF, D
3. Valuation ratios
4. Complications
 - a. Negative values
 - b. Value creation and destruction

Figure 1.1 Lundholm & Sloan, *Framework for Equity Valuation*

Stages of the Analysis



external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

Analysis of Financial Statements

- understanding current F/S
- re-formulating the F/S
- accounting quality

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Industry dynamics

→ Porter's five forces

(suppliers, buyers, new entrants, substitutes, rivalry)

- analysts' reports
- management forecasts
- financial press
- ???

➤ Financial Statements – AASB 101:

- Balance Sheet
- Income Statement *and/or* Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Cash Flows
- Notes to the financial statements

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➤ building blocks → definition <https://eduassistpro.github.io/>

➤ accounting principles → AASB / IFRS rules [Add WeChat edu_assist_pro](#) accounting decisions/choices

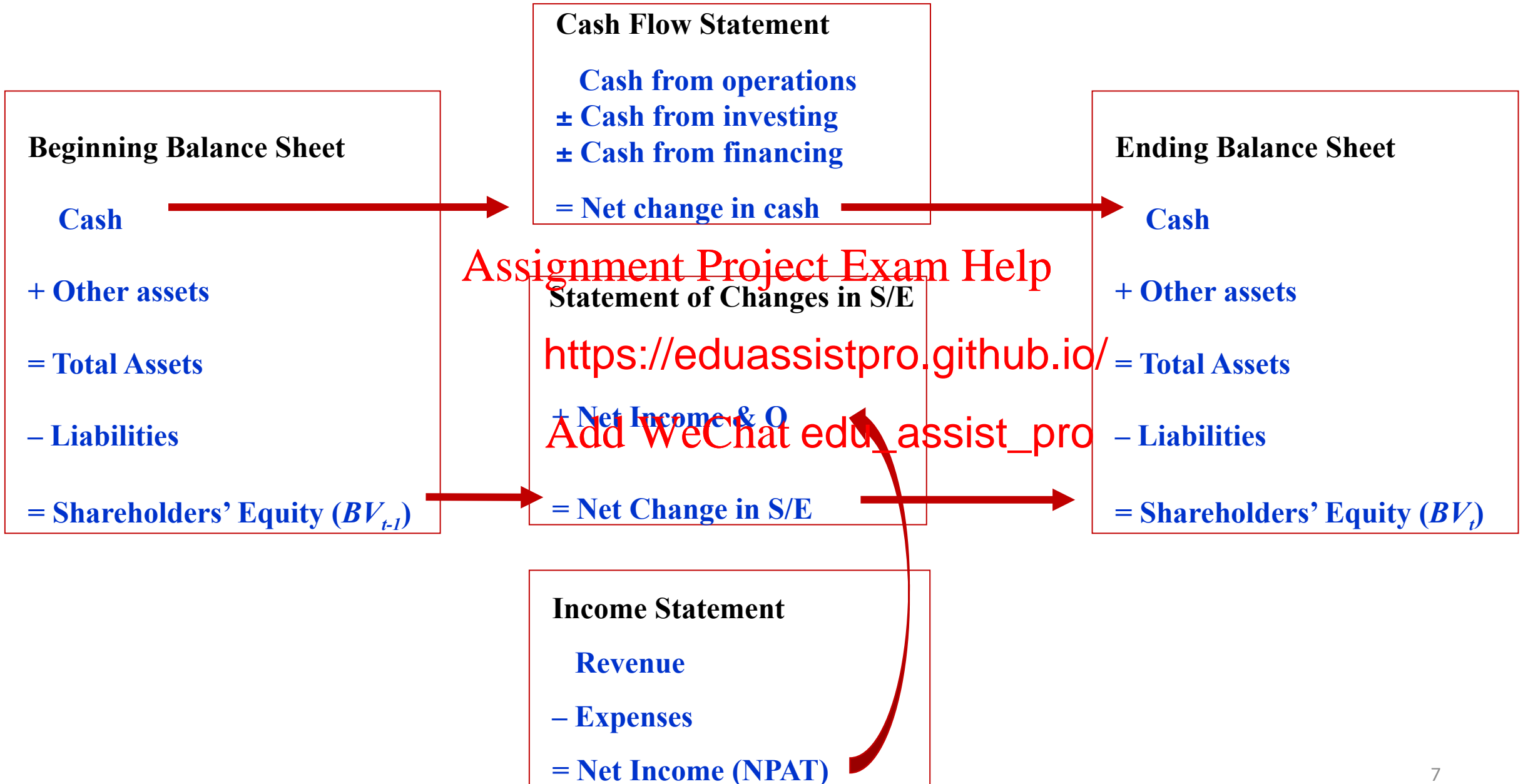
➤ recognition (item to F/S) *versus* disclosure (notes)

‘articulation’ → Financial Statements constitute an **‘integrated system’**

beginning stock

flows

ending stock



pro forma Income Statement

	2019	2020	2021E	2022E	2023E
Sales	38,176	37,408	± ?	± ?	± ?
Other operating revenue	288	376			
Cost of sales	(29,253)	(28,043)	± ?	± ?	± ?
Other income	426	408			
Administrative expenses			± ?	± ?	± ?
Other expenses					
Share – equity investments	5	(
Financing costs	(42)	(443)	± ?	± ?	± ?
Income tax expense	(347)	(341)	± ?	± ?	± ?

caution – for ‘clean surplus’ and consistent estimates, the accounting system must reconcile

⇒ **‘articulation’**: must concurrently develop the *pro forma* B/S and SCF

PART 2 – Reformulation Preliminaries

▪ Objectives:

- separate **operating** activities from **financing** activities
- fix-up some accounting classifications (relatively few)
- for the Income Statement, expenses based on their *driver* (sales volume or other), and whether they are recurring or non-recurring

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➤ separation of a company's **operations** from how those operations are **financed**

- ❑ *Operations*: buying and selling goods and services
- ❑ *Financing*: the company's use of debt and equity to finance its operations, as well as the company's investment in financial assets

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➤ Why separate the two?

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- industrial companies generate value from operations, not from their financial activities
- financial activities can hide a company's true operating performance

➔ notion of '**levered**' versus '**unlevered**'

Levered ➔ measured **after** the effects of financial activities

- ➔ reflect the company's operations and the effects of financial activities
- ➔ levered metrics capture the shareholders' perspective

Unlevered ➔ measured **before** the effects of financial activities

- ➔ reflect purely the company's operations
- ➔ unlevered metrics capture the combined lender/shareholder perspective

In general: **Unlevered metrics = Levered metrics + Effects of financing**

note – this disaggregation can be applied at the overall firm level, as well as individually with the B/S, I/S, and SCF

levered *

- firm after financing charges
- to only common shareholders

unlevered *

- firm before financing charges
- to debt + equity

* need to adjust both for tax

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applied to valuation

$$\text{market value of net operating assets} = \text{market value of equity} + \text{market value of net financial obligations}$$

$$\square \quad \text{market value of equity} = \text{market value of net operating assets} - \text{market value of net financial obligations}$$

‘market value of NOA’ is often called *unlevered value* (EV)

- the market value of the company’s operating assets
- ‘*unlevered*’ because it measures the value of the company before net debt is added

‘market value of equity’ is also called the market capitalisation (market cap)

- ‘*levered*’ because it measures the value of the company after removing the value of net debt (financing activities)

‘market value of NFO’ represents the company’s financing activities

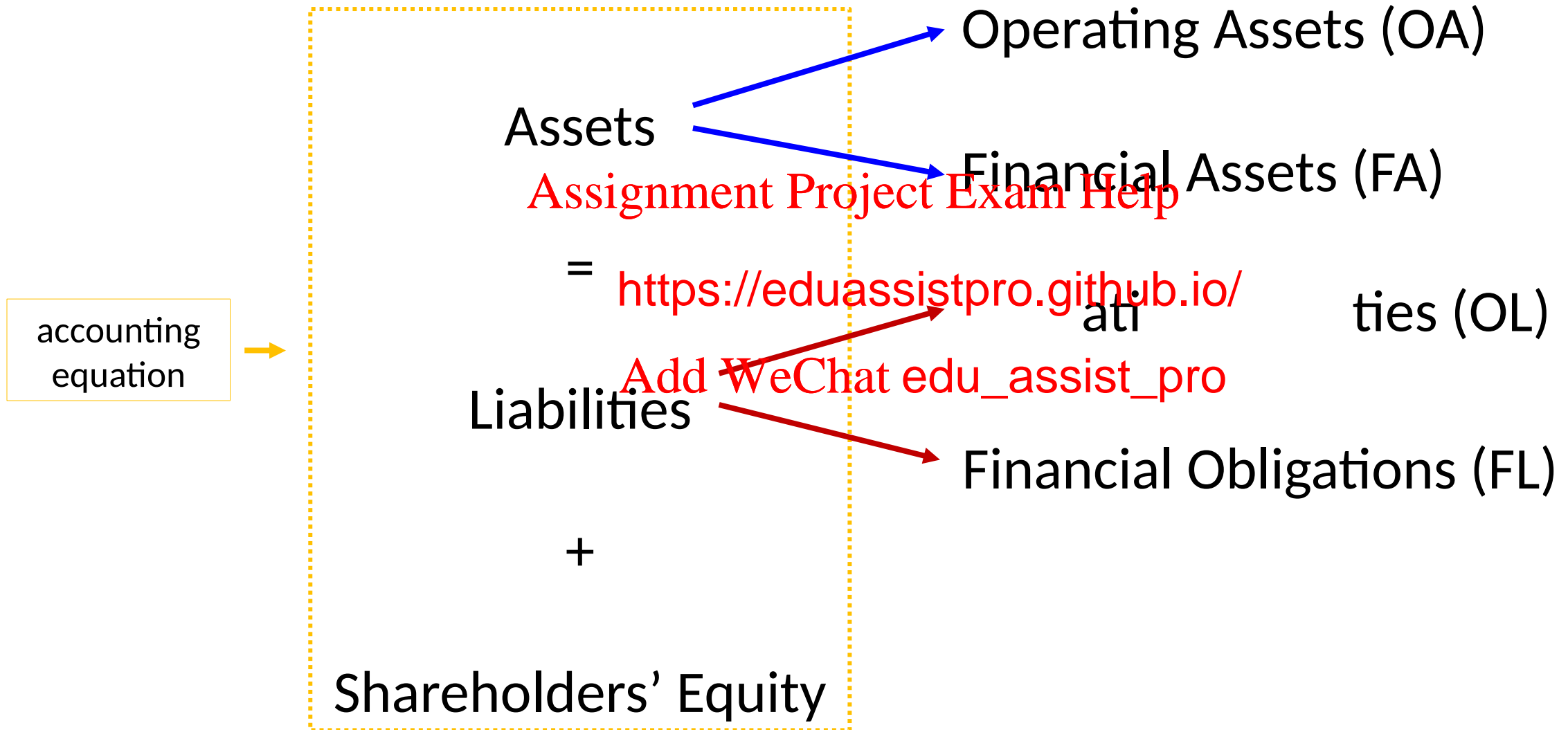
	Balance Sheet (Book Value)	Income Statement	Our Valuation	Market Valuation
Operating activities	NOA	OI (after-tax)	V_F	MV_F
Debt financing	NFO/NFA	NFE (after-tax)	V_D	MV_D
Equity financing	CSE	CI	V_E	MV_E
	$NOA = CSE + NFO$ $CSE = NOA - NFO$	$OI = CI + NFE$ $CI = OI - NFE$	$V_F = V_E + V_D$ $V_E = V_F - V_D$	$MV_F = MV_E + MV_D$ $MV_E = MV_F - MV_D$

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PART 3 – Balance Sheet Reformulation



$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Shareholders' Equity (S/E)}$$

$$[\text{OA} + \text{FA}] = [\text{OL} + \text{FO}] + \text{S/E}$$

□

reformulating → $(\text{OA} - \text{OL}) = (\text{FO} - \text{FA}) + \text{S/E}$

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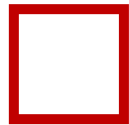
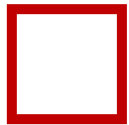
$$\begin{array}{ccccc} \text{net operating assets} & & \text{net financial} & & \text{Shareholders' Equity} \\ & = & & + & \\ (\text{OA} - \text{OL}) & & (\text{FO} - \text{FA}) & & \text{S/E} \end{array}$$



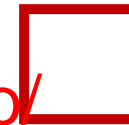
AASB / IFRS Balance Sheet

Assets		Liabilities & Equity	
Operating Assets	OA	Operating Liabilities	OL
Financial Assets	FA	Financial Obligations	FO
		Shareholders' Equity	S/E
Total Assets	OA + FA	Total Claims	OL + FO + S/E

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Reformulated B

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Net Operating Assets		Financial Obligations & Shareholder's Equity	
Operating Assets	OA	Financial Obligations	FO
Operating Liabilities	OL	Financial Assets	(FA)
		Net Financial Obligations	NFO
		Shareholders' Equity	S/E
Total	OA – OL	Total	NFO + S/E

Step #1 – Operating Assets (OA) versus Financial Assets (FA)

- *Operating Assets (OA)* – essentially assets used in selling goods and services (the company's business)
- *Financial Assets (FA)* – essentially assets used to invest excess cash (i.e. financial investments not tied to the company's business)

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Aside: there is an active debate in the best to achieve this separation (e.g., Barker, 2010, *Accounting and Business* <https://eduassistpro.github.io/> have not adopted this structure for IFRS reporting!

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There are two broad things to consider (Barker,

- **nature** of the item itself e.g., p,p&e is inherently operational (physical assets that are used in production) compared to an investment in government bonds
- **function** of the item in the company's operations e.g., a retail company does not generate profits from trading financial securities, but a hedge fund does → investments in financial securities are likely a FA for a retail company, but an OA for a hedge fund

Typical Operating Assets (OA):

- *Operating cash* (see later slide)
- *Accounts Receivable*: almost always an OA, but check that it isn't a hidden loan to another company
- *Inventory*: almost always an OA
- *Prepaid expenses*: check whether it is an OA
- *Goodwill*: almost always an OA
- *Equity-accounted investments* (e.g., investments in associates/JVs): usually an OA, but check nature of the investment to ensure it is related to the company's operations
- *Property, plant & equipment* (p,p&e): almost always OA
- *Intangibles*: almost always OA
- *Deferred tax assets*: treat this as an OA in this course

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Typical indicators of Financial Assets (FA) (none are decisive on their own):

- the item is financial nature, such as investments in debt/equity securities
- typically measured at fair value e.g., investments in debt or equity
- typically earn interest or dividends for the company
- the asset is not integrated into the company's operations (could be sold without disrupting anything) and/or the company is not expected to generate value above ordinary investment returns

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Typical Financial Assets (FA): Add WeChat edu_assist_pro

- financial cash (see later slide)
- short-term investments
- investments in debt or equities securities (without control/significant influence e.g., an investment in another company's bonds or a small <20% equity stake in another company)

note – there is sometimes room for disagreement about what constitutes a OA and FA for a particular company. Use your judgement where there is doubt, but make sure you can justify your decision

aside:

- in the Balance Sheet, assets and liabilities are classified into current and non-current – this distinction does not place the Balance Sheet; rather, similar current and non-current assets (e.g., short-term and long-term bank loans)

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‘common’ problem areas –

- ❖ cash & cash equivalents
- ❖ investment properties
- ❖ ‘other assets’

❑ Cash & Cash Equivalents

- most businesses need some cash to operate i.e., to meet day-to-day cash flows (transaction motive) → 'working cash' → 'operating cash' ≡ OA
- *however*, many businesses maintain much larger cash balances than they need for daily operations → 'financial cash' ≡ FA

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- separating operating cash (O <https://eduassistpro.github.io/>) is a matter of **judgement**
- things to consider: [Add WeChat edu_assist_pro](#)
 - competitor cash balances
 - the company's historical cash balances
 - nature of the company's operations
- a classic approach (used by the textbook and often in practice) is to **assume** operating cash is some percentage of sales (e.g., 0.5% of sales)

❑ *Investment Properties*

- for most companies, land and buildings will be an OA i.e., the company uses them in its operations (perhaps a factory)
- *however*, some/all of a company's land and buildings can be FA in the following circumstances:
 - the land and buildings are clearly excessive to the company's needs
 - they are rented/leased
 - they are accounted for using 'AASB 14 Investment Property' (note - investment properties can be carried at fair value)

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❑ *'Other assets'*

- check the notes for details about what 'Other assets' means (if provided)
 - if the company provides a break-down, classify each component as OA or FA depending upon details
 - if the company provides no information, usually it is safe to assume they are OA

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- OA / FA (0.5%)
- OA (after checking note)
- OA (after checking note)
- FA
- OA (after checking note)
- OA (after checking note)

	28 JUNE 2020	30 JUNE 2019
NOTES	\$M	\$M
Non-current assets		
Property, plant and equipment		
Right-of-use assets		
Intangible assets		
Deferred tax assets		
Equity accounted investments		
Other assets		
Total non-current assets		

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- OA (after checking note)
- OA (after checking note)
- OA (after checking note)
- OA (after checking note)
- OA (after checking note)
- OA (after checking note)

PART 4 – Reformulating the Balance Sheet (cont)

Step #2 – Operating Liabilities (OL) versus Financial Obligations (FO)

- *Operating Liabilities (OL)* – liabilities associated with selling goods and services (i.e. the company's business)
- *Financial Obligations (FO)* – sources of financing other than CSE (basically debt)

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Typical indicators of Financial Obligations (FO):

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- the company pays interest on them and has an obligation to repay
- most are measured at amortised cost (or rarely fair value)
- the liability is not integrated with the company's operations, e.g. an industrial company could switch a bank loan for a bond without much disruption, but couldn't easily separate its provision for warranty expenses from its operations

❑ Typical Operating Liabilities (OL):

- Accounts Payable: almost always an OL (but if the company has to pay interest, you should investigate whether it is a hidden FO)
- Accrued Expenses: almost always an OL
- Provisions: almost always a OL, but check the notes
- Deferred revenue
- Deferred tax liabilities: tre
- Income tax payable

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❑ Typical Financial Obligations (FO):

- Interest-bearing liabilities/loans
- Lease obligations
- Notes/bonds (in liabilities)
- Preference shares and other hybrid securities

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❑ Dividends payable is sometimes classified into Current Liabilities

- this make no sense from a shareholder perspective – can't owe ourselves money!
- why do accountants recognise dividends payables in current liabilities?
- we will instead treat Dividends payable as part of CSE

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❑ Preference shares (or preferred shares) are usually classified as part of Equity

- preference shares are usually a type of hybrid that does not neatly fit the definition of Liability or Equity
- from the common shareholder perspective, *preference* shares should be classified as a FO and dividends on preference shares should be classified as a financial expense

□ Derivative Securities

- 'derivative financial assets' and 'derivative financial liabilities' basically represent unrealised gains/losses on derivative contracts
- *conceptually*, classification should depend on why the company uses the derivative – to illustrate,
 - if it is an interest rate swap used to hedge interest rate risk related to a loan, then the derivative asset/liability should be an FA/FO
 - if it is forward contract risk on the purchase of an operating asset, then the derivative asset should be an OA/OL
- given the challenges in specifically confirming each contract, we will treat 'derivative financial assets' as FA and 'derivative financial liabilities' as FO

❑ Leases

- leases appear on both the asset and liabilities side of the Balance Sheet
- historically came in two varieties:

Operating leases: basically rental agreements

the company does not recognise the leased asset or the associated liability on the Balance Sheet; but recognised an 'operating lease expense' on the Income Statement

Finance/capital leases: basically a loan to buy an asset

the company recognises the depreciation and interest on the Balance Sheet; and associated expense on the Income Statement

- under the new AASB 16, operating leases will disappear and all leases will be recognised as finance leases

⇒ treat financial lease assets as OA and lease obligations as FO
treat lease interest as a financial expense

* Note 2.9 reveals that 2019 'provisions' include amounts for 'lease provisions' = FO

	CONSOLIDATED	
	28 JUNE 2020	30 JUNE 2019
	NOTES	
Liabilities		
Current liabilities		
Trade and other payables		
Provisions		
Lease liabilities		
Other		
Total current liabilities		
Non-current liabilities		
Interest-bearing liabilities		
Provisions		
Lease liabilities		
Other		
Total non-current liabilities		
Total liabilities		

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- OL (after checking note)
- OL/FO (after checking note)
- FO (after checking note)
- OL (assumed)
- FO (after checking note)
- OL/FO (after checking note)
- FO (after checking note)
- OL (assumed)

Reformulation Summary - Coles

	2020	2019			2020	2019
OA	17,502	9,028		FA	847	749
OL	<u>5,297</u>	<u>4,308</u>		FO	<u>10,437</u>	<u>112</u>
					9,590	(637)
				S	<u>2,615</u>	<u>3,357</u>
NOA	12,205	2,720		N	12,205	2,720

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applied to valuation

$$\begin{array}{ccccc} \text{market value of net} & & \text{market value} & & \text{market value of net} \\ \text{operating assets} & = & \text{of equity} & + & \text{financial obligations} \end{array}$$

‘market value of equity’ (16 December)

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$$= 1,334 \text{ million shares} \times \$18.16 = \$24,225.44 \text{ million}$$

‘market value of NFO’ – most p
market valuation

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(accounting) value of NFO instead of

→ \$9,590

➡ ‘market value of net operating assets’ (enterprise value)

$$= \$24,225.44 \text{ million} + \$9,590 = \$33,815.44 \text{ million}$$

PART 5 – Income Statement Reformulation

overview – reformulation of the AASB/IFRS Income Statement and Statement of Comprehensive Income into a Reformulated Income Statement such that it:

1. divides Income Statement items into operating versus financing activity related
2. further divides operating in **Assignment Project Exam Help** es, based on whether the items are recurring and driven by <https://eduassistpro.github.io/>
3. reallocates income tax expense to remove **Add WeChat edu_assist_pro** debt financing/financial assets
4. divides OCI into operating and financing aspects

Process (as per schema on the next slide) -

Step #1: divide every line item in the Income Statement between operating and financing

Step #2: divide operating items into:

- core operating income from sales
- core other operating income
- unusual operating income

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Step #3: divide income tax exp

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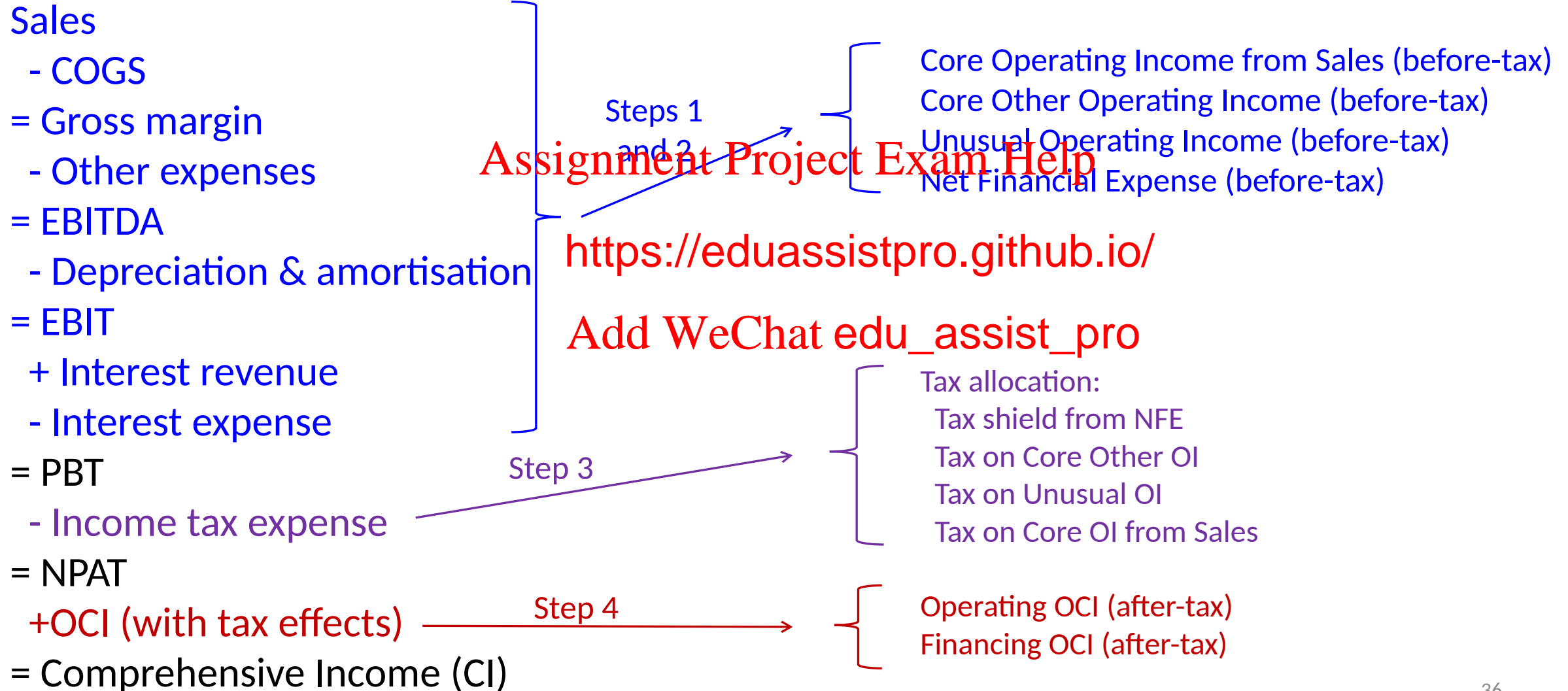
- core operating income from sales
- core other operating income
- unusual operating Income
- net financial expense (or net financial income)

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Step #4: divide OCI items (after-tax) between operating and financing

AASB/IFRS Income Statement & Statement of Comprehensive Income

Reformulated Income Statement



Step #1: divide every line item in the Income Statement between operating and financing

- ❑ **Operating** items: revenues/expenses (or gains/losses) related to the company's operations e.g., sales, COGS, wages, advertising, depreciation, etc.
- ❑ **Financing** items: revenues/expenses (or gains/losses) related to the company's financing activities e.g., interest revenue, interest expense, etc.

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- consider information in the company's operating model (use judgement)
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- try to be consistent in how you reformulate the I/S
 - operating revenues/expenses should relate to operating assets/liabilities
 - financial income/expenses should relate to financial assets/obligations
e.g., if a company's 'equity-accounted investments' are classified as a FA, then 'share of profits of equity-accounted investments' should be a financial gain/loss

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□ Typical operating items:

- sales or revenue from sales of goods/provision of services
- cost of goods sold or cost of sales
- wages and salaries or employee benefits
- advertising
- research and development
- selling, general & administrative expenses (SG&A)
- repairs and maintenance
- depreciation and amortisation
- operating lease expense
- share of profits/loss on equity-

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□ Typical financial items:

- interest revenue or financial revenue
- interest expense or financial expense
- finance lease expense
- dividend revenue from financial assets
- gain/loss on revaluation of financial assets reported in the income statement (e.g. investment property, financial securities)

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lacking Notes on 'other operating revenue' and 'other income', will treat all items as 'operating items' except 'financing costs' which will be classified as a 'financial item'

PART 6 – Reformulating the Income Statement (cont)

Step #2: divide 'operating items' into:

- core operating income from sales
 - recurring operating income related to the company's main operations (driven by sales volume) e.g., sales, COGS, wage expense
- core other operating income
 - recurring operating income that is not related to the company's main operations (not driven by sales volume) e.g., share of profits of equity-accounted investments, royalty income
- unusual operating income
 - non-recurring (one-time) operating income e.g., restructuring charges, extraordinary items, gain/loss on sale of PPE

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Why these classifications? **facilitates forecasting**

Why separate 'core operating income' and 'unusual operating income'?

- when evaluating historical performance, it is useful to know whether earnings was affected by unusual items e.g., suppose a company makes \$100m in profit, but \$80m came from a one-time gain on selling surplus land
- when forecasting, it is useful to know whether an item is likely to repeat in the future e.g., a loss due to a flood

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Why then further split 'core operating income' into 'core operating income from sales' and 'core other operating income'?

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- for forecasting purposes, it is useful to know the 'driver' of an item
- items in 'core operating income from sales' are likely to be associated with sales volume (e.g., COGS), whereas items in 'core other operating' are likely driven by other factors (e.g., royalty income)

☐ Core versus Unusual

- **core** items occur every year, and are fairly stable and predictable
- **unusual** items do not occur every year, or vary greatly from year-to-year and/or are unpredictable
- restructuring charges, extraordinary items, impairments, asset/business sales are generally **unusual items**, they are not recurring
- clues as to what be non-r other sections of the annual report and the company's investor presentation rise judgement; do not necessarily follow the company's advice if an item looks like it is actually a normal expense or recurring)

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note – 'other comprehensive income (OCI)' is considered separately in Step #4; we will implicitly treat all OCI items as 'unusual'

❑ Core Operating Income from Sales *versus* Core Other Operating Income

- typical 'core operating income from sales':
 - sales or revenue from sales of goods/provision of services
 - cost of goods sold or cost of sales
 - wages and salaries or employee benefits
 - advertising
 - research and developm
 - selling, general & administrative expen
 - repairs and maintenance
 - depreciation and amortisation

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- typical 'core other operating income':
 - royalty income
 - rental income (not related to Investment property, which would be financing)
 - grant income
 - share of profits/loss on equity-accounted investments
 - 'other income'
 - income from 'side businesses' broken out on the income statement

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- Core OI from sales
- Core other OI
- Core OI from sales
- Core other OI
- Core OI from sales & Unusual OI*
- Core financing expense (NFE)
- Core other OI
- Core financing expense (NFE)
- Step #3
- Unusual OI

* Note 1.4 indicates that 'Administrative expenses' include an 'impairment reversal' of \$41 million in 2020 and an 'impairment expense' of \$42 million in 2019 → 'Unusual OI'

Summary – Coles reformulated Income Statement (following Steps #1 & #2)

	2020	2019
Core OI from Sales (before tax)	1,243	934
Core Other OI (before tax)	478	721
Core OI (before tax)	1,721	1,655
Unusual OI (before tax)		315
Core NFE (before tax)		(188)

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* 2020 reconciles; 2019 does NOT – tax adjustment on ‘discontinued’

versus reported profit before tax from the I/S

	2020	2019
Profit before tax	1,319	1,425

Process –

✓ **Step #1:** divide every line item in the Income Statement between operating and financing

✓ **Step #2:** divide operating items into:

- core operating income from sales
- core other operating income
- unusual operating income

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Step #3: divide income tax expense between

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- core operating income from sales
- core other operating income
- unusual operating income
- net financial expense (or net financial income)

Step #4: divide OCI items (after-tax) between operating and financing

PART 7 – Summary: Sessions #1 → #6

overarching objective:

to conduct fundamental value for the purpose of estimating the ‘intrinsic value’ of a firm’s common shares

→ requires an understanding of the firm’s ‘value drivers’

➔ need to accumulate a ‘tool kit’ as the basis for developing the *pro forma Financial Statement*

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STEP 1 Understanding the past

1. Information collection
2. Understanding the business
3. Accounting analysis
4. Financial ratio analysis
5. Cash flow analysis



STEP 2 Forecasting the future

1. Structured forecasting
2. Income Statement forecasts
3. Balance sheet forecasts
4. Cash flow forecasts



STEP 3 Valuation

1. Cost of capital
2. Valuation models – AE, FCF, D
3. Valuation ratios
4. Complications
 - a. Negative values
 - b. Value creation and destruction

external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

Analysis of Financial Statements

- understanding current F/S
- re-formulating the F/S
- accounting quality

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Industry dynamics

→ Porter's five forces

(suppliers, buyers, new entrants, substitutes, rivalry)

- analysts' reports
- management forecasts
- financial press
- ???