Module 3

# The Language and Tools of Financial Analysis

## Limitations 3: Profit versus Wealth Creation (Raising the bar)

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## The Problem with Accounting

Financial statements (and their analysis) are geared towards a single objective, shareholder profit maximisation

$$Profit = Revenue - Expenses$$

Corporations on the other hand have shifted focus to wealth maximization – providing a longer-term business decision horizon, paving the way for sustainable business operations

## Shareholder wealth maximization

Corporations focus on other aspects than just profits (sales, market share) which will lead to sustainable profit …

and profit maximization is therefore a subset of wealth creation for shareholders

requires management to continuously search for the highest possible returns on shareholder funds invested in the business, while mitigating any associated risk of loss

## Shareholder wealth maximization

Wealth maximization focuses on cash flows rather than profit:

When evaluating various business propositions, management considers the net present value of future cash flows generated by each proposition,

using Discounted Cash Flow methodology – accounting for the time value of money (timing of future cash flows) and risk (of future cash flows)

## Shareholder wealth maximization

Direct evidence of wealth maximization is signalled by changes in the market value of equity (the share price)

If a firm invests cash to develop valuable new intellectual property, shareholders will recognize the future positive cash flows associated with this new investment by bidding up the price of the shares

…which is not easily reflected in the financial statements

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