Question 6.
Juan Perez argues that “learning how to do business analysis and valuation using financial statements is not very useful, unless you are interested in becoming a financial analyst.” Comment.
Business analysis and valuation skills are useful not only for financial analysts but also for corporate managers and loan officers. Business analysis and valuation skills help corporate managers in several ways. First, by using business analysis for equity security valuation, corporate managers can
assess whether the firm is properly valued by investors. With superior information on a firm’s strategies, corporate managers can perform their own equity security analysis and compare theirSolutions – Chapter 1
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estimated “fundamental value” of the firm with the current market price of share. If the firm is not properly valued by outside investors, corporate managers can help investors to understand the firm’s business strategy, accounting policies, and expected future performance, thereby ensuring that the stock price is not seriously undervalued.
Second, using business analysis for mergers and acquisitions, corporate managers (acquiring management) can identify a potential takeover target and assess how much value can be created through acquisition. Using business analysis, target management can also examine whether the acquirer’s offer is a reasonable one.
Loan officers can also benefit from business analysis, using it to assess the borrowing firm’s liquidity,
solvency, and business risks. Business analysis techniques help loan officers to predict the likelihood
of a borrowing firm’s financial distress. Commercial bankers with business analysis skills can examine whether or not to extend a loan to the borrowing firm, how the loan should be structured, and how it should be priced.
Question 7.
Four steps for business analysis are discussed in the chapter (strategy analysis, accounting analysis,
financial analysis, and prospective analysis). As a financial analyst, explain why each of these steps is
a critical part of your job and how they relate to one another.
Managers have better information on a firm’s strategies relative to the information that outside financial analysts have. Superior financial analysts attempt to discover “inside information” from analyzing financial statements. The four steps for business analysis help outside analysts to gain valuable insights about the firm’s current performance and future prospects.
• Business strategy analysis is an essential first step because it enables the analysts to frame the subsequent accounting, financial, and prospective analysis better. For example, identifying the key success factors and key business risks allows the identification of key accounting policies. Assessment of a firm’s competitive strategy facilitates evaluating whether current profitability is sustainable. Finally, business strategy analysis enables the analysts to make sound assumptions in forecasting a firm’s future performance.
• Accounting analysis enables the analysts to “undo” any accounting distortion by recasting a firm’s accounting numbers. Sound accounting analysis improves the reliability of conclusions from financial analysis.
• The goal of financial analysis is to use financial data to evaluate the performance of a firm. The outcome from financial analysis is incorporated into prospective analysis, the next step in financial statement analysis.
• Prospective analysis synthesizes the insights from business strategy analysis, accounting analysis, and financial analysis in order to make predictions about a firm’s future.Solutions – Chapter 1
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Problem 1. The Neuer Markt
1. Do you think that exchange market segments such as the EuroNM markets can be a good alternative to venture capital? If not, what should be their function?
2. This chapter described four institutional features of accounting systems that affect the quality of financial statements. Which of these features may have been particularly important in reducing the quality of Neuer Markt companies’ financial statements?
3. The decline of the Neuer Markt could be viewed as the result of a ‘lemons problem.’ Can you think of some mechanisms that might have prevented the market’s collapse?
4. What could have been the Deutsche Börse’s objective of introducing two new segments and letting Neuer Markt firms choose and apply for admission to one of these segments? When is this strategy most likely to be effective?
1. In general, exchange market segments such as the EuroNM markets cannot effectively serve as an alternative to venture capital. Firms that obtain venture capital are typically firms with large information problems. That is, the degree of information asymmetry between these firms’ insiders and potential investors is high because start-up firms’ inside information is often highly proprietary (risk of other firms entering the same market) or their operating environment is highly uncertain and/or unstable. These information problems cannot be easily overcome by means of public reporting (because information is proprietary, the environment changes quickly, management has strong incentives to misreport, or management still needs to build a reputation etc.). Instead, venture capitalists obtain insider access to the firms’ private information and use their expertise to separate good from bad business ideas.
The function of the EuroNM markets should be to offer venture capitalists the opportunity to cash in on their investments once the start-up firms have reached a more mature development phase and their business idea has proven successful (i.e., there are less information problems). If this opportunity is available, venture capitalists will have a stronger incentive to screen and finance (smaller) business ideas.
2. (Note that the four features are: accrual accounting, accounting conventions and standards, auditing, reporting strategy):
a. Accrual accounting: the large investments in intangibles (goodwill, R&D etc.) and tangibles (PP&E, inventories) made by fast-growing, innovative start-up companies tend to make the difference between cash accounting and accrual accounting more pronounced.