Palepu
Healy
Bernard

Business Analysis & Valuation

Using Financial Statements

Second Edition

AMERICAN ACCOUNTING ASSOCIATION
Wildman Medal
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Text & Cases

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preface

Financial statements are the basis for a wide range of business analysis. Managers use them to monitor and judge their firms' performance relative to competitors, to communicate with external investors, to help judge what financial policies they should pursue, and to evaluate potential new businesses to acquire as part of their investment strategy. Securities analysts use financial statements to rate and value companies they recommend to clients. Bankers use them in deciding whether to extend a loan to a client and to determine the loan's terms. Investment bankers use them as a basis for valuing and analyzing prospective buyouts, mergers, and acquisitions. And consultants use them as a basis for competitive analysis for their clients. Not surprisingly, therefore, we find that there is a strong demand among business students for a course that provides a framework for using financial statement data in a variety of business analysis and valuation contexts. The purpose of this book is to provide such a framework for business students and practitioners.

The first edition of this book has been successful well beyond our original expectations. The book has been used in Accounting and Finance departments in business schools in the U.S. and around the world.

CHANGES FROM THE FIRST EDITION

Many of our colleagues who used the first edition provided us with valuable feedback. Based on this feedback, we made the following changes:

- We expanded the coverage of accounting issues in the text. There are now five new chapters that provide analytical approaches to evaluating a firm's accounting choices and estimates with respect to assets, liabilities, entities, revenues, and expenses. The materials in these chapters cover a variety of accounting transactions.
- We expanded and revised extensively the chapters on valuation in order to make the material more accessible, and also to reflect the growing body of accounting research in this area.
- We included a discussion of corporate strategy in the strategy analysis chapter. In the previous edition, we focused only on industry analysis and the competitive positioning of a company in a single industry. The new material helps students analyze multibusiness organizations as well.

- We used a variety of company situations to help illustrate the concepts. In the previous edition, we used one company example throughout the book.
- We included fifteen new cases in this edition. However, we also retained several popular cases from the previous edition because they have proved to be very effective for many instructors.
- To facilitate the selection of cases, we paired each chapter with a case that we think is best suited to illustrate the concepts in that chapter. However, to retain some flexibility for instructors, we also included a set of multipurpose cases at the end of the book.
- To supplement the cases, we added conceptual questions and problems at the end of each chapter. These questions can be used in class discussions or for after-class assignments.

KEY FEATURES

This book differs from other texts in business and financial analysis in a number of important ways. We introduce and develop a framework for business analysis and valuation using financial statement data. We then show how this framework can be applied to a variety of decision contexts.

Framework for Analysis

We begin the book with a discussion of the role of accounting information and intermediaries in the economy, and how financial analysis can create value in well-functioning markets. We identify four key components of effective financial statement analysis:

- Business Strategy Analysis
- Accounting Analysis
- Financial Analysis
- Prospective Analysis

The first of the components, business strategy analysis, involves developing an understanding of the business and competitive strategy of the firm being analyzed. Incorporating business strategy into financial statement analysis is one of the distinctive features of this book. Traditionally, this step has been ignored by other financial statement analysis books. However, we believe that it is critical to begin financial statement analysis with a company's strategy because it provides an important foundation for the subsequent analysis. The strategy analysis section discusses contemporary tools for analyzing a company's industry, its competitive position and sustainability within an industry, and the company's corporate strategy.

Accounting analysis involves examining how accounting rules and conventions represent the firm's business economics and strategy in its financial statements, and, if necessary, developing adjusted accounting measures of performance. In the accounting analysis section, we do not emphasize accounting rules. Instead, we develop general approaches to analyzing assets, liabilities, entities, revenues, and expenses. We believe that such an approach enables students to effectively evaluate a company's accounting choices and accrual estimates, even if students have only a basic knowledge of accounting rules and standards.

Financial analysis involves analyzing financial ratio and cash flow measures of operating, financing, and investing performance of a company, relative either to key competitors or historical performance. Our distinctive approach focuses on using financial analysis to evaluate the effectiveness of a company's strategy and to make sound financial forecasts.

Finally, under prospective analysis we show how to develop forecasted financial statements and how to use these to make estimates of a firm's value. Our discussion of valuation includes traditional discounted cash flow models as well as techniques that link value directly to accounting numbers. In discussing accounting-based valuation models, we integrate the latest academic research with traditional approaches, such as earnings and book value multiples that are widely used in practice.

While we cover all four components of business analysis and valuation in the book, we recognize that the extent of their use depends on the user's decision context. For example, bankers are likely to use business strategy analysis, accounting analysis, financial analysis, and the forecasting portion of prospective analysis. They are less likely to be interested in formally valuing a prospective client.

Application of the Framework to Decision Contexts

The next section of the book shows how our business analysis and valuation framework can be applied to a variety of decision contexts, including:

- Securities Analysis
- Credit Analysis
- Corporate Financing Policies Analysis
- Merger and Acquisition Analysis
- Management Communications Analysis

For each of these topics we present an overview chapter to provide a foundation for the class discussions. Where possible we discuss relevant institutional details and the results of academic research that are useful in applying the analysis concepts developed earlier in the book. For example, the chapter on credit analysis shows how banks and rating agencies use financial statement data to develop analysis for lending decisions and to rate public debt issues. This chapter also discusses academic research on how to analyze whether a company is financially distressed.

CASE APPROACH

We have found that teaching a course in business analysis and valuation is significantly enhanced, both for teachers and students, by using cases as a pedagogical tool. Students want to develop "hands-on" experience in business analysis and valuation so that they can apply the concepts in decision contexts similar to those they will encounter in the business world. Cases are a natural way to achieve this objective by presenting practical issues that might otherwise be ignored in a traditional classroom exercise. Our cases all present business analysis and valuation issues in a specific decision context, and we find that this makes the material more interesting and exciting for students.

To provide both guidance and flexibility in the choice of cases, we include one case at the end of each chapter, especially chosen for applying the concepts in that chapter. The multipurpose cases at the end of the book can be used with more than one chapter.

USING THE BOOK

We designed the book so that it is flexible for courses in financial statement analysis for a variety of student audiences–MBA students, Masters in Accounting students, executive program participants, and undergraduates. Depending upon the audience, the instructor can vary the manner in which the conceptual materials in the chapters, end-of-chapter questions, and case examples are used.

Prerequisites

To get the most out of the book, students should have completed basic courses in financial accounting, finance, and either business strategy or business economics. The text provides a concise overview of some of these topics, primarily as background for preparing the cases. But it would probably be difficult for students with no prior knowledge in these fields to use the chapters as stand-alone coverage of them. We have integrated only a small amount of business strategy into each case, and do not include any cases that focus exclusively on business strategy analysis.

The extent of accounting knowledge required for the cases varies considerably. Some require only a basic understanding of accounting issues, whereas others require a more detailed knowledge at the level of a typical intermediate financial accounting course. However, we have found it possible to teach even these more complex cases to students without a strong accounting background by providing additional reading on the topic. For some cases, the Teaching Manual includes a primer on the relevant accounting issue, which instructors can hand out to help students prepare the case.

How to Use the Text and Case Materials

The materials can be used in a variety of ways. If the book is used for students with prior working experience or for executives, the instructor can use almost a pure case approach, adding relevant lecture sections as needed. However, when teaching students with little work experience, a lecture class can be presented first, followed by an appropriate case. It is also possible to use the book primarily for a lecture course and include some of the cases as in-class illustrations of the concepts discussed in the book.

Alternatively, lectures can be used as a follow-up to cases to more clearly lay out the conceptual issues raised in the case discussions. This may be appropriate when the book is used in undergraduate capstone courses. In such a context, cases can be used in course projects that can be assigned to student teams.

We have designed the cases so that they can be taught at a variety of levels. For students that need more structure to work through a case, the Teaching Manual includes a set of detailed questions that the instructor can hand out before class. For students who need less structure, there are recommended questions at the end of each case.

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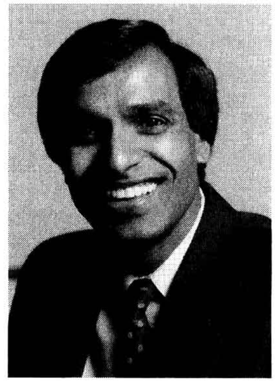

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Paul Healy is the MBA Class of 1949 Professor of Business Administration at the Harvard Business School. Professor Healy's research has focused on corporate disclosure policies and their impact on the cost of capital, the effectiveness of mergers and acquisitions, earnings management, and management compensation. He has previously worked at the MIT Sloan School of Management, ICI Ltd., and Arthur Young in New Zealand. Professor Healy has won the Notable Contributions to Accounting Literature Award (in 1990 and 1999) and the Wildman Award (in 1997) for contributions to practice.

Vic Bernard, who passed away November 14, 1995, was a CPA and held a PhD from the University of Illinois. He was the Price Waterhouse Professor of Accounting and Director of the Paton Accounting Center at the University of Michigan and Director of Research for the American Accounting Association. His research examined issues in financial reporting, financial statement analysis, and financial economics. He received the Notable Contributions to Accounting Literature Award in 1991, 1993, and 1999, the Outstanding Accounting Educator Award in 1997, and the Wildman Award in 1997.

contents

part 1

Framework

chapter 1

A Framework for Business Analysis and Valuation Using Financial Statements

The purpose of this chapter is to outline a comprehensive framework for financial statement analysis. Because financial statements provide the most widely available data on public corporations' economic activities, investors and other stakeholders rely on financial reports to assess the plans and performance of firms and corporate managers.

A variety of questions can be addressed by business analysis using financial statements, as shown in the following examples:

- A security analyst may be interested in asking: "How well is the firm I am following performing? Did the firm meet my performance expectations? If not, why not? What is the value of the firm's stock given my assessment of the firm's current and future performance?"
- A loan officer may need to ask: "What is the credit risk involved in lending a certain amount of money to this firm? How well is the firm managing its liquidity and solvency? What is the firm's business risk? What is the additional risk created by the firm's financing and dividend policies?"
- A management consultant might ask: "What is the structure of the industry in which the firm is operating? What are the strategies pursued by various players in the industry? What is the relative performance of different firms in the industry?"
- A corporate manager may ask: "Is my firm properly valued by investors? Is our investor communication program adequate to facilitate this process?"
- A corporate manager could ask: "Is this firm a potential takeover target? How much value can be added if we acquire this firm? How can we finance the acquisition?"
- An independent auditor would want to ask: "Are the accounting policies and accrual estimates in this company's financial statements consistent with my understanding of this business and its recent performance? Do these financial reports communicate the current status and significant risks of the business?"

Financial statement analysis is a valuable activity when managers have complete information on a firm's strategies and a variety of institutional factors make it unlikely that they fully disclose this information. In this setting, outside analysts attempt to create "inside information" from analyzing financial statement data, thereby gaining valuable insights about the firm's current performance and future prospects.

To understand the contribution that financial statement analysis can make, it is important to understand the role of financial reporting in the functioning of capital markets and the institutional forces that shape financial statements. Therefore, we present first a brief description of these forces; then we discuss the steps that an analyst must perform to extract information from financial statements and provide valuable forecasts.

THE ROLE OF FINANCIAL REPORTING IN CAPITAL MARKETS

A critical challenge for any economy is the allocation of savings to investment opportunities. Economies that do this well can exploit new business ideas to spur innovation and create jobs and wealth at a rapid pace. In contrast, economies that manage this process poorly dissipate their wealth and fail to support business opportunities.

In the twentieth century, we have seen two distinct models for channeling savings into business investments. Communist and socialist market economies have used central planning and government agencies to pool national savings and to direct investments in business enterprises. The failure of this model is evident from the fact that most of these economies have abandoned it in favor of the second model—the market model. In almost all countries in the world today, capital markets play an important role in channeling financial resources from savers to business enterprises that need capital.

Figure 1-1 provides a schematic representation of how capital markets typically work. Savings in any economy are widely distributed among households. There are usually many new entrepreneurs and existing companies that would like to attract these savings to fund their business ideas. While both savers and entrepreneurs would like to do business with each other, matching savings to business investment opportunities is complicated for at least two reasons. First, entrepreneurs typically have better information than savers on the value of business investment opportunities. Second, communication by entrepreneurs to investors is not completely credible because investors know entrepreneurs have an incentive to inflate the value of their ideas.

Figure 1-1 Capital Markets