

Financial Analysis: A User Approach

Chapter 2

The Financial Environment

Capital Market Participants:

- Commercial Banks
- Investment Banks
- Private Equity
- Stock Market
- Bond Market
- Mutual Funds
- Insurance Companies
- Regulatory Agencies
- Analysts Community
- Financial Accounting Standard Setters

Primary vs. Secondary Markets

Capital Sources

- Equity
- Debt

The Securities and Exchange Commission (SEC)

- Overall Mission - *Protect investors and maintain the integrity of securities markets*
- Commission
 - Structure
 - Appointments
- Divisions
 - Corporate Finance
 - Required Filings
 - Registration Statement
 - 10-K
 - 10-Q
 - Proxy
 - Financial Accounting Standards
 - Enforcement
- Sarbanes Oxley (SOX)
 - Senior Official Certifications
- Current Events

Financial Reporting

- The Financial Accounting Standards Board (FASB) and the Financial Accounting Foundation (FAF)
- The Relationship of the FASB and the SEC
- FASB Due Process:
 - Item added to agenda
 - Discussion Memorandum
 - Exposure Draft
 - Financial Accounting Standard
- The Emerging Issues Task Force (EITF)

International Accounting Standards and Convergence

- The International Accounting Standards Board (IASB)
- Memorandum of Understanding between IASB and FASB
- SEC Commitment and Timetable to International/US Accounting Standard Convergence

Basic Financial Statements

- Income Statement
- Balance Sheet
- Statement of Cash Flows
- Footnotes
- Management's Discussion and Analysis (MD&A)

Management Incentives and Financial Reporting

- Management's Primary Responsibility
- Conflicts of Interest Between Management and Shareholders
- Earnings Management
- Earnings Manipulation
- Timing Differences for Revenues and Expenses

Theoretical Perspectives Related to the Financial Environment

- Efficient Markets
 - Semi-strong form – all publically available information is immediately impounded into a stock's market price
 - Implication – abnormal returns cannot be earned by fundamental analysis
 - Research findings
 - Other forms of the efficient markets hypothesis
 - Strong Form – All information is reflected
 - Weak Form - Previous security price movements are reflected
 - Paradox implied by this perspective
- Random Walk
 - You can't beat the market consistently

- The Capital Asset Pricing Model (CAPM)
 - Diversified Portfolios achieve and optimal risk return position
 - $E(R_i) = R_f + \beta[E(R_m) - R_f]$
 - *where*
 - R_i = Rate of return of stock i
 - R_f = Risk-free rate of return
 - R_m = Rate of return on the market
 - β = The firm's *beta* (the relationship of the firm's returns to the market's returns)
 - E = Expected Value or Forecast
 - Interpreting Beta
 - Beta = 1
 - Beta < 1
 - Beta > 1

- Agency Theory
 - Principal – Agent Model
 - Contracting as a Means to Minimize, Subject to Contracting Costs, Principle Agent Conflicts of Interest
 - Agency Costs
 - Information Asymmetry
 - Adverse Selection
 - Moral Hazard

- Bounded Rationality
 - Rational, but subject to constraints
 - Opportunism

- Earnings Management and Accounting Choice
 - Accounting Policy Choices
 - Income Smoothing
 - Recurring vs. Nonrecurring

- Economic Consequences
 - Impact of New Accounting Standards