<table>
<tr><th>Concepts</th><th colspan="3">Description</th></tr>
<tr><td colspan="4">Integration of FS Analysis techniques</td></tr>
<tr><td>Framework for analysis of FS</td><td colspan="3">Main purpose of FS analysis : identify outcomes (good / bad) that could affect an investment decision
Framework for analysis of FS : used in making decisions abt EQT ownership interet in firm, leding decision, evaluate credit rating, anticipate impact of change in accounting standards on firm</td></tr>
<tr><td rowspan="7">Framework for analysis of FS - 6 steps</td><td></td><td>Input</td><td>Output</td></tr>
<tr><td>Step 1 : Establish the objectives</td><td>- Perspective of analysis (e.g.: evaluating debt / EQT investment / issuing credit rating)
- Needs / concerns of client / supervisor
- Institutional guideline</td><td>- Purpose statement
- Specific questions to be answered
- Nature / content of final report
- Budget timetable and resources</td></tr>
<tr><td>Step 2 : Collect data</td><td>- FS
- Communication with management, suppliers, customers, competitors</td><td>- Organised financial information</td></tr>
<tr><td>Step 3 : Process data</td><td>- Data from step 2</td><td>- Adjusted FS
- Common size statements
- Ratios
- Forecasts</td></tr>
<tr><td>Step 4 : Analyse data</td><td>Data from step 2 & 3</td><td>- Results</td></tr>
<tr><td>Step 5 : develop & communication</td><td>- Result from analysis
- Published report guidelines</td><td>- Report answering questions stated in Step 1
- Recommendations</td></tr>
<tr><td>Step 6 : Follow up</td><td>- Periodically updated information</td><td>- Updated analysis and recommendations</td></tr>
<tr><td>FR choices and biases and impact on the quality and comparability of FS</td><td colspan="3">1. Sources of earnings and ROE
DuPont equation : ROE = Tax burden x Interest burden x EBIT margin x Total asset turnover x Financial leverage
→ identify performance driver, weaker areas that are covered by other stronger areas
Consider firm's source of income internally generated (more control) vs externally generated (income generated by ownership of interest in associate - less control) → eliminate equity income to analyse the performance from the firm's own asset base

2. Asset base : Require test of changes in composition of BS assets over time (commonly in a common-size BS)

3. Capital structure : Must be able to support the strategic objectives + meet the future obligations
- Analyse thru financial leverage ratios
- Some liabilities are more burdensome than others (e.g.: Financial and bond liabilities default if not paid on time or non-compliant with covenants; employees obligations, deferred taxed, restructuring provisions are less burdensome, and may not require future cash outflow

4. Capital allocation :
- Conso FS could hide individual characteristics of dissimilar subs → require to separate financial info by segments (portion accounts for > 10% of revenues or assets ; different risks and returns from other lines of business
- Valuable to identify :
+ each segment's contribution to revenue and profit
+ relationship between CAPEX and rate of return
+ which segment should be de-emphasized / eliminated
- Ratios :
+ % CAPEX / % assets for each segment > 0 → growing segment by allocating more assets → more significant proportion over time, and vice versa
+ Comparing EBIT margin of each segment with % CAPEX / % assets → determine whether the firm is investing in its most profitable segment
* Note : Accrual-based measures (EBIT) might not be a good indicator of the ability to generate CF → estimated CF = EBIT + Depreciation + Amortisation</td></tr>
<tr><td>Effect of MS modification, earning normalisation and CF modification on FS, financial ratios, and overall financial condition</td><td colspan="3">1. Eaning quality and CF analysis
Step 1 : Accruals ratio (Accruals / Average net operating assets) : used to measure eanings quality. Lower accruals ratios → higher eanings quality. 2 approaches:
a. BS approach :
$Accruals\ ratios = \frac{Accruals}{(Net\ operating\ assets_{Ending} + Net\ operating\ assets_{Opening})/2}$
In which:
$Accruals = Net\ operating\ assets_{Ending} - Net\ operating\ assets_{Opening}$
$Net\ operating\ assets = Operating\ assets - Operating\ liabilities$
$Net\ operating\ assets = [Total\ assets - (cash + cash\ equivalent + marketable\ securities)] - (Total\ liabilites - Total\ ST\ and\ LT\ debt)$
b. CF approach :
$Accruals\ ratios = \frac{Accruals}{(Net\ operating\ assets_{Ending} + Net\ operating\ assets_{Opening})/2} = \frac{NI - CFO - CFI}{(Net\ operating\ assets_{Ending} + Net\ operating\ assets_{Opening})/2}$
- Wide fluctuation → indication of earning manipulation by increasing accruals → compare CF to operating income
Step 2 : Compare CF to operating income
$\frac{Cash\ generated\ from\ operations\ (CGO)}{Operating\ income} = \frac{EBIT + (Non-cash\ charges) - Increase\ in\ Working\ Cap}{Operating\ income}$
Step 3 : Examine cash return on total assets from acquisition
$CF\ to\ reinvestment = \frac{CGO}{CAPEX}$ $CF\ to\ total\ debt = \frac{CGO}{Total\ debt}$ $CF\ interest\ coverage = \frac{CGO}{Cash\ interest\ paid}$
2. Market value decomposition
- Parent company has ownership interest in associate → should determine the implied value of parent without % share of associate
- Implied value = MV of parent = parent's pro rata share of associate's MV (should convert to parent reporting currency)</td></tr>
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