There are several ways in which financial statement analysis can add value, even when capital markets are reasonably efficient. First, there are many applications of financial statement analysis whose focus is outside the capital market context—credit analysis, competitive benchmarking, and analysis of mergers and acquisitions, to name a few. Second, markets become efficient precisely because some market participants rely on analytical tools such as the ones we discuss in this book to analyze information and make investment decisions. This in turn imposes greater discipline on corporate managers to develop an appropriate disclosure and communication strategy.

SUMMARY

Financial statements provide the most widely available data on public corporations' economic activities; investors and other stakeholders rely on them to assess the plans and performance of firms and corporate managers. Accrual accounting data in financial statements are noisy, and unsophisticated investors can assess firms' performance only imprecisely. Financial analysts who understand managers' disclosure strategies have an opportunity to create inside information from public data, and they play a valuable role in enabling outside parties to evaluate a firm's current and prospective performance.

This chapter has outlined the framework for business analysis with financial statements, using four key steps: business strategy analysis, accounting analysis, financial analysis, and prospective analysis. The remaining chapters in this book describe these steps in greater detail and discuss how they can be used in a variety of business contexts.

DISCUSSION QUESTIONS

1. John, who has just completed his first finance course, is unsure whether he should take a course in business analysis and valuation using financial statements since he believes that financial analysis adds little value, given the efficiency of capital markets. Explain to John when financial analysis can add value, even if capital markets are generally seen as being efficient.
2. In 2009, Larry Summers, former Secretary of the Treasury, observed that "in the past 20-year period, we have seen the 1987 stock market crash. We have seen the Savings & Loan debacle and commercial real estate collapse of the late 80's and early 90's. We have seen the Mexican financial crisis, the Asian financial crisis, the Long Term Capital Management liquidity crisis, the bursting of the NASDAQ bubble and the associated Enron threat to corporate governance. And now we've seen this [global economic crisis], which is more serious than any of that. Twenty years, seven major crises. One major crisis every three years." How could this happen given the large number of financial and information intermediaries working in financial markets throughout the world? Can crises be averted by more effective financial analysis?
3. Accounting statements rarely report financial performance without error. List three types of errors that can arise in financial reporting.
4. Joe Smith 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.
5. 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.