Corporate Finance, Module 24: “Financial Analysis and Planning”

Required reading, Eighth Edition:

Updated: November 22, 2005

{The Brealey and Myers textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Read section 29.2, “Executive Paper’s Financial Statements” on pages 784-788. (Section 29.1 is an introduction that is not needed for this course.) A firm has three major financial statements: the balance sheet, the income statement, and the sources and uses of funds. The financial statements *articulate*, meaning that various relations hold among them. For example, a debit or a credit can appear on either the balance sheet or the income statement, and the form in which it appears affects the change in equity over the year.

Read section 29.3, “Measuring Executive Paper’s Financial Condition,” on pages 789-797. This module covers the ratios in Table 29.4 on page 790. After reading each sub-section, come back to this table, find the figures in the three financial statements, and be sure you understand how the ratio is formed.

Insurers have similar ratios; the NAIC has IRIS ratios that determine whether an insurer must undergo a financial examination. The insurance ratios differ from the ratios in Table 29.4 because reserve requirements are the crux of insurance solvency. Non-insurers don’t have reserves, and insurers don’t have the basic building blocks of most other firms, such as inventories and fixed assets. But the concepts are the same for insurers and other firms.

Look at question 1 in the quiz on page 804, which refers to the balance sheet and income statement in Table 29.8 on page 805. If you can not form the requested ratios, review the material in the text.