

# EFR summary

Advanced Financial Statement  
Analysis

2025 - 2026



Week 1-2

**Deloitte.**

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# Lecture 1: Introduction & Strategy Analysis

Through this course you will understand how to evaluate companies using financial information, which is essential for investors, analysts, and finance professionals.

Example: Facebook's IPO

- Facebook went public in May 2012 (IPO on NASDAQ).
- Stock prices are determined by supply and demand.
- However, investors still need to determine the true value of a share.

How is this done? → Through Financial Statement Analysis (FSA).

Financial statements help investors evaluate profitability, growth potential, risks

Example: Stock Market Bubble at the end of 1990

Main idea: Stock prices can deviate from the fundamental value of companies.

- P/B ratio: Price / Book Value of Equity
- P/V ratio: Price / Fundamental Value

If ratios  $>1$ , stock price is higher than fundamental value.

Conclusion: Financial Statement Analysis helps:

- identify true value drivers
- detect overvalued companies.

## Accounting Refresher

### Accounting Example

Scenario: Company A starts operations on **January 1, 2022**.

Initial investment: owner invests **€500,000 cash**.

Balance sheet at start:

<b>Assets</b>		<b>Equity</b>	
Cash	500,000	Owners' equity	500,000

### Book entry:

Cash	500,000	(debit)
Equity	500,000	(credit)

Now assume that the following transactions take place during the year:

Several business transactions occur:

1. A purchases an office (other assets) for 100,000 cash;
2. A purchases a machine (other assets) for 20,000 cash;
3. A purchases inventory for 200,000, 100,000 is paid in cash, 100,000 on credit;
4. A sells 75% of the inventory for 250,000 on credit (cash has not been received at the end of the year)

### Cash Accounting Result

$$500,000 - 100,000 \text{ (Office)} - 20,000 \text{ (Machine)} - 100,000 \text{ (Inventory)} = 280,000$$

Assets		Equity	
Cash	280,000	Equity	280,000

Important: The credit sale (250,000) is not recorded yet because no cash has been received. Problem with cash accounting: It ignores economic activity that hasn't yet generated cash. This is why **accrual accounting** is used instead.

### Income Statement (P&L)

Expense		Revenue	
COGS	150,000	Sales	250,000
Profit	100,000		

### Book entry

Profit	100,000
Equity	100,000

### Balance Sheet

Asset		Liabilities & Equity:	
Cash	280,000	Owners' equity	600,000
Inventory	50,000	Accounts payable	100,000
Accounts receivable	250,000		
Other assets	120,000		
	<u>700,000</u>		<u>700,000</u>

### Accrual Accounting

- Accrual accounting records economic activity, not just cash.
- This produces a more accurate measure of performance.

Change in non-cash assets: 420,000 (Inventory 50,000 + Accounts receivable 250,000 + Other assets 120,000)

Change in liabilities:  $\frac{-100,000}{320,000}$  (Accounts payable)

Total accruals: 320,000

These total accruals exactly explain the difference between the net income on a cash accounting basis (i.e., the total cash flow) and the net income on an accrual accounting basis ("earnings")

Key formula: Net income = Cash flows + Accruals

100 = - 220 + 320

### Financial Statement Analysis

- Capital markets connect: Investors (savers) → Companies needing capital
- But there is a major issue: Separation between *ownership* and *control*
  - Shareholders = owners, Managers = decision makers
  - Managers have more information than investors.
- Therefore: Financial statement analysis helps outsiders: Understand company performance and Estimate future prospects.
- Example users: Financial analysts, Investors, Credit analysts.

Households (investors) provide: Savings / capital. Businesses receive: Investment funds. Between them are two types of intermediaries.

1. *Financial intermediaries*. Examples: Banks, Venture capital, Pension funds, Investment funds. They allocate capital.
2. *Information intermediaries*. Examples: Auditors, Financial analysts, Rating agencies, Financial press. They analyze and verify information.

### Two problems exist:

**Adverse Selection:** Before investment. Managers know more about company quality than investors. Investors cannot easily distinguish: good companies/bad companies.

**Moral Hazard:** After investment. Managers may use resources for personal benefit and make decisions that do not maximize shareholder value.

These problems lead to: **The “Lemons Problem” (Akerlof 1970)**

Investors cannot identify good investments. Result:

- Investors value good and bad investments at average prices
- Good companies leave the market
- Bad companies remain

Eventually: Markets may break down.

Financial statement analysis helps reduce this problem.

### Role of Intermediaries

To prevent financial markets from breaking down due to information problems, *intermediaries* help reduce information asymmetry. Example: A mechanic certifying a used car's quality. Two main types of intermediaries:

#### 1. Financial intermediaries

Organizations that focus on aggregating funds from individual investors and analyzing different investment alternatives to make investment decision.

→ Examples: Venture capital firms, Banks, Pension funds, Insurance companies, Investment funds

#### 2. Information intermediaries

Organizations that focus on providing information to investors on the quality of investment opportunities. Their role is to reduce information asymmetry between managers and investors.

→ Examples: Auditors, Financial analysts, Credit rating agencies, Financial press

### The Accounting System

Financial statements summarize the economic consequences of business activities.

The **accounting system**:

- Measures business transactions
- Reports them in financial statements.

Because of this, financial statement analysis must consider how accounting rules influence the numbers.

## Four institutional features

of accounting systems that affect financial statements.

### Feature 1: Accrual Accounting

Accrual accounting separates: Economic activity from Cash payments and receipts

- This means: Revenue and expenses are recorded when they occur, not when cash is received or paid.
- Example: A company sells goods on credit today. Revenue is recorded today. Cash may arrive later.
- Accrual accounting provides a better representation of company performance than cash accounting.

### Feature 2: Accounting Conventions & Standards

Managers must make estimates and judgments when preparing financial statements. Examples: Asset valuations, Depreciation, Inventory valuation

- **Benefits:** Managers can include inside information about the business in financial reports.
- **Costs :** Managers may manipulate earnings to achieve goals (earnings management).

Because of this accounting standards are created to limit misuse of accounting discretion. However, strict rules can also reduce managers' ability to reflect real economic conditions. Therefore, analysts must evaluate how accounting choices affect reported numbers.

### Feature 3: Managers' Reporting Strategy

Managers decide how much information to disclose.

Key questions:

- Do they provide additional voluntary disclosure?
- Do they hide poor performance?

Possible strategies e.g. Full disclosure, Manipulating investor perceptions

Example: Managers might delay bad news or emphasize positive results.

### Feature 4: Auditing, Legal Liability and Enforcement

External mechanisms that improve financial reporting quality. Auditing verifies the integrity of reported financial statements. Threat of lawsuits and resulting penalties have the beneficial effect of improving the quality of disclosure. Public enforcement bodies further enhance the pressure for high quality financial statements.

Examples of regulators: SEC (USA), AFM (Netherlands)

## Four Steps of Financial Statement Analysis

Financial statement data contains both:

- Real economic information
- Possible distortions or noise

Therefore analysts must carefully interpret accounting numbers.

These four steps aim to extract true economic information from financial statements.

### 1. Strategy Analysis (lecture 1)

Generate performance expectations through industry analysis and competitive strategy analysis

### 2. Accounting Analysis (lecture 2)

Evaluate accounting quality by assessing accounting policies and estimates

### 3. Financial Analysis (lecture 3)

Evaluate performance using ratios and cash flow analysis

### 4. Prospective Analysis (lecture 4)

Make forecasts and value business

## Strategy Analysis

Strategy analysis is important because it helps analysts understand the economics of the business. It allows analysts to:

- Understand **how the company makes money**
- Identify **key profit drivers**
- Identify **major risks**
- Evaluate whether current performance is **sustainable**

Analysts should understand: The company's industry, Competitive forces and Diversification and synergies. Without understanding the business model, financial numbers are difficult to interpret.

**Porter's Five Forces model** of industry structure and profitability.

### Competition within the industry

1. Rivalry among existing firms
2. Threat of new entrants
3. Threat of substitute products

## Bargaining power in markets

4. Bargaining power of buyers
5. Bargaining power of suppliers

## Competitive Force 1: Rivalry Among Existing Firms

When rivalry is **high**, competition pushes prices down.

Consequences:

- Prices approach **marginal cost**
- Profit margins decrease
- Companies compete on **non-price factors** (quality, branding, innovation).

Factors determining rivalry:

- Industry growth rate
- Number and balance of competitors
- Economies of scale
- Ratio of fixed to variable costs

## Competitive Force 2: Threat of New Entrants

If new firms can **easily enter an industry**, profits decline.

Reasons: More competitors → Increased supply → Price competition.

Barriers to entry determine the threat.

Important barriers include:

- Economies of scale
- First-mover advantage
- Customer and supplier relationships
- Legal barriers (e.g., patents or regulation).

Example: Pharmaceutical companies have strong patent protection, reducing entry.

## Competitive Force 3: Threat of Substitutes

Substitutes are **alternative products that satisfy the same need**.

Examples: Train vs airplane, Streaming vs cinema

When substitutes exist:

- Customers can switch easily
- Companies cannot raise prices easily.

Factors affecting substitutes:

- Relative price
- Performance of alternatives
- Customer willingness to switch.

More substitutes → lower industry profitability.

### Competitive Force 4: Bargaining Power of Buyers

Buyers can push **prices downward** if they have strong bargaining power.

Factors influencing buyer power:

- Price sensitivity
- Availability of alternatives
- Size and importance of buyers.

Example: Large retailers negotiating with suppliers.

### Competitive Force 5: Bargaining Power of Suppliers

Suppliers can push **input prices upward** if they have strong bargaining power.

Suppliers gain power when:

- Few suppliers exist
- Products are specialized
- Switching suppliers is difficult.

### Strategy Analysis and the Rest of FSA

Insights from strategy analysis help the other steps of financial statement analysis.

- Accounting Analysis : Evaluate whether accounting reflects business reality.
- Financial Analysis: Use financial data to evaluate past performance and current financial position.
- Prospective Analysis: Forecast future earnings and future growth.

# Lecture 2 – Accounting Analysis

## Lecture 1: Recap

### Porter's Five Forces model

#### Rivalry among existing firms

Decreases when there is an high industry growth, few strong competitors, high entry costs. Increases when there is an stagnant industry, many similar competitors

#### Threat of new entrants

Decreases when there are large capital needs. Increases when easy online entry

#### Threat of substitutes

Decreases when there is few realistic alternatives for customers and high switching costs. Increases when there are many cheap or convenient alternatives.

### **Bargaining power of suppliers**

Decreases when there are many alternative suppliers, easy to switch.

Increases when there are few key suppliers, specialized inputs, high switching costs.

### **Bargaining power of buyers**

Decreases when fragmented customers, products differentiated.

Increases when large buyers, high price transparency.

## Accounting Analysis

The **purpose** of accounting analysis is to **evaluate how well financial statements reflect the true economic reality of a business.**

- Identify areas where accounting flexibility exists
- Evaluate accounting policies and estimates used by the company

Main objectives:

1. Assess the degree of distortion in financial statements
2. Undo distortions if they exist

Accounting analysis is important for several reasons:

### **1. Better Ratio Analysis**

We want ratios to be based on the most informative and reliable numbers.

### **2. Forecasting**

Analysts must determine whether current revenues and earnings are sustainable.

→ Example: If managers inflate earnings this year, earnings next year will likely be lower. This is known as: The "Iron Law of Accrual Reversal".

Meaning: Accrual accounting adjustments tend to reverse over time.

### **3. Firm Valuation**

Valuation models rely on forecasts, so they must reflect economic reality rather than distorted accounting numbers.

Financial statements can become distorted due to three main sources:

### **1. Noise in Accounting Rules**

It is often difficult for standard setters to restrict management discretion without losing valuable information (e.g., R&D)

### **2. Forecast Errors**

Managers cannot perfectly predict the future (e.g., probability of collecting payments)

### 3. Managers' Accounting Choices

Managers may intentionally choose accounting methods to achieve reporting objectives. Possible motives include: meeting earnings targets, influencing stock prices, meeting debt covenants

#### 6 Steps in Accounting Analysis

1. Identify key accounting policies
2. Assess accounting flexibility
3. Evaluate accounting strategy
4. Evaluate quality of disclosure
5. Identify potential red flags
6. Recast financial statements and remove distortions

#### Step 1: Identify Key Accounting Policies

Key accounting policies depend on industry characteristics and competitive strategy. These determine the critical success factors and risks of a firm. Analysts should evaluate how companies measure these factors.

For Example, Banking Industry: Main risks are interest rate risk and credit risk  
→ Accounting impact: loan loss reserves

For Example, Manufacturing Industry: Important factors are R&D and product quality  
→ Accounting impact: warranty expenses and warranty reserves

#### Step 2: Assess Accounting Flexibility

Analysts must evaluate how much flexibility managers have in reporting numbers.

- Accounting flexibility differs by industry because of accounting rules.
- Areas that usually involve flexibility: depreciation methods, inventory valuation, amortization of intangibles, pension benefit estimation

For Example,

High flexibility: Banks estimating expected loan defaults. Low flexibility: Marketing expenses in consumer products must usually be expensed immediately.

#### Step 3: Evaluate Accounting Strategy

If managers have accounting flexibility, they can use it in two ways:

- Informative reporting: Communicate the firm's real economic performance.
- Opportunistic reporting: Hide poor performance or manipulate earnings.

Analysts should evaluate: managers' reporting incentives, deviations from industry norms, history of accounting errors, complex transactions or structures

#### Step 4: Evaluate Quality of Disclosure

Analysts must assess whether disclosures help or hinder understanding.

Good disclosure makes financial statements easier to interpret.

Key aspects to examine: accounting choices, explanations of financial performance, non-financial information, segment reporting, discussion of bad news, quality of investor relations

#### Step 5: Identify Red Flags

Red flags are warning signals that accounting quality may be questionable.

They indicate areas where analysts should investigate more closely and gather additional information.

Examples of possible red flags: unexplained accounting changes, unusual revenue growth, unexplained transactions, unexpected large asset write-offs

#### Step 6: Recast Financial Statements

If accounting distortions are identified, analysts should adjust the financial statements, this is called recasting.

- Restate the numbers if the analysis suggests the reported numbers are misleading
- Cash flow statement provides an alternative benchmark and shows how individual line items in the income statement diverge from underlying cash flows
- Notes to the financial statements provide additional information about accounting changes and estimates made

#### Pitfalls in Accounting Analysis

##### 1. Common standards ≠ common practices

Even if countries adopt the same accounting standards (e.g., IFRS), reporting quality can still differ. Reason:

- Differences in legal systems
- Differences in regulation and enforcement
- Differences in institutional quality

So adoption of IFRS does not automatically guarantee high-quality financial reporting.

##### 2. Not all unusual accounting is questionable

Unusual accounting choices do not necessarily mean manipulation.

Explanations: unusual business models or changes in business circumstances.

Analysts must investigate the economic reason behind accounting choices.

### 3. Conservative accounting is not always good accounting

Conservatism means systematically understating assets or earnings.

Potential problems:

- Understatement of assets
- Important information missing from financial statements

Example: R&D investments often create value but may not appear as assets.

### 4. Conservatism can lead to earnings smoothing

Managers may:

- Report **lower earnings in good times**
- Save reserves to **increase earnings in bad times**

This leads to **earnings smoothing**, which can distort real performance.

**Question:** If management reports truthfully, what economic events might explain the following accounting change?

#### **Decrease in allowance for doubtful accounts (% of receivables)**

- Change in the customer base
- Larger sale from reliable customers.

#### **Capitalization of a higher proportion of development expenditures**

- Cost incurred on product development are to be capitalized
- If the company completes the product design earlier than it initially expected, it can capitalize a higher proportion of development costs during that period

## Accounting adjustments

### Accounting Equation Elements

#### • **Assets**

Definition: Economic resources controlled by the firm that produce **future benefits**.

Examples: machinery, buildings, patents, receivables

#### • **Liabilities**

Definition: Present obligations that will result in **future outflows of resources**.

Examples: loans, accounts payable, pension obligations

#### • **Equity**

Represents the residual claim of shareholders. Formula:  $\text{Equity} = \text{Assets} - \text{Liabilities}$

- **Income**

Increase in economic benefits during the accounting period.

Examples: sales revenue, investment income

- **Expenses**

Decrease in economic benefits during the accounting period.

Examples: wages, depreciation, raw materials

An asset is: A **resource controlled by the entity**, Resulting from **past events**, From which **future economic benefits are expected**

A liability is: A **present obligation**, Arising from **past events**, Expected to cause an **outflow of economic benefits**

**Example:** Are the following items qualify as assets on December 31, 2022?

**Example 1: Machine**

A company buys a machine for €1.5 million on January 1, 2022.

By December 31: The machine is ready for use. But it has not been used yet.

- 1. Controlled by the entity?** Yes. The company owns and controls the machine.
- 2. Result of past events?** Yes. The machine was purchased earlier in the year.
- 3. Expected future economic benefits?** Yes. The machine will be used to produce goods in the future.

Conclusion: The machine qualifies as an asset, even though it has not yet been used.

**Example 2: Trademark**

A smartphone company's **registered trademark** is estimated to be worth **€30 billion**. Question: Should this value appear as an asset on the balance sheet?

- 1. Controlled by the entity?** Yes. The firm owns the trademark.
- 2. Result of past events?** Yes. The trademark was created and registered.
- 3. Expected future benefits?** Yes. The brand generates future sales.

However, accounting standards create a restriction:

Internally generated trademarks usually cannot be recognized as assets.

Reason: Their value cannot be measured reliably.

This creates a balance sheet distortion because the brand may be extremely valuable but not reported.

## Example: Liability?

### Example 1 – Short-term loan

In mid-2022, the company borrowed €10 million from its bank. Reason: Lack of liquidity. Question: Is this a liability at December 31, 2022?

- 1. Present obligation?** Yes. The company must repay the bank.
- 2. Result of past events?** Yes. The loan agreement already occurred.
- 3. Expected outflow of resources?** Yes. Repayment will require cash outflow.

Conclusion: The loan clearly qualifies as a liability.

### Example 2 – Product recall

A defect is discovered in smartphones sold three years earlier. Problem: They require constant recharging. The company announces a product recall. Question: Does this create a liability?

- 1. Present obligation?** Yes. The firm publicly announced it and must fix the problem.
- 2. Result of past events?** Yes. The defect originated from **past production errors**.
- 3. Expected outflow of resources?** Yes. Costs will include: repair or replacement, logistics, customer compensation

Conclusion: A **provision for product recall** should be recognized as a liability