Financial Statement Analysis and Valuation (code 2163)
Date: 3th May 2005
Time: 4 hours
Aids: calculator (not programmable)
Professor: Stefan Sundgren

1. Palepu et al presents a number of different forms of asset (and earnings) overstatements and understatements:
    a. Discuss some of the most common forms according to Palepu et al (10 p)
    b. Discuss also briefly different reasons why firms could have the incentive to overstate or understate assets (and earnings) (5 p)

2. Palepu et al presents 5 different steps of the credit analysis / commercial lending process. Present and discuss them! (5 p)

3. Discuss briefly the following issues related to the role of financial reporting as a means of investor communication (5 p):
    a. How can reporting be used to communicate with investors?
    b. What factors increase the credibility of accounting communication?
    c. What alternative medias than finanical reporting can be used to communicate with investors?

4. Nordic Construction Ltd (fictitious) is a privately held company that plans to go public. It has currently operations in the Nordic countries and plans to enter the Baltic countries and Russia during the next few years. Financial statements for 2004 and 2005 as well as forecasts for 2006 – 2010 are enclosed. Answer the following questions related to the valuation of the company:
    a. Calculate the value of the company's equity in the end of 2005 using the discounted abnormal earnings model. Assume that all flows (earnings and expenses) arrive in the end of the year, that the cost of equity is 12 percent and that the abnormal earnings continue to growth at the same rate after 2011 as the average rate 2008 to 2009 and 2009 to 2010. (5 p)
    b. How would the valuation change if you instead assume that the flows arrive mid-year? (1 p)
    c. Do you think the assumptions about the growth rate after 2010 are realistic in (a)? Why / Why not? Discuss at a general level what type of implications that the competition in an industry could have for assumptions about the growth rate of abnormal earnings after the forecast horizon. (4 p)
    d. The P/B (price-to-book) ratios of two other companies in the industry are 2 and 1,6. Mr Lazy claims that the value could be easily calculated using just the average P/B ratio of those two firms multiplied with Nordic Construction's book value of equity. Under what circumstances do you think that such a valuation would be (a) correct and (b) wrong? (5 p)

Good luck!
(max 40p – min 20p to pass)

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