Contents

| List of Cases xxv | The Income Statement 36 The Cash Flow Statement 40 |
|--|---|
| List of Accounting Clinics xxvi | The Statement of Shareholders' Equity 40 |
| Chapter 1 Introduction to Investing and Valuation 2 | The Footnotes and Supplementary Information to Financial Statements 41 The Articulation of the Financial Statements: |
| Investment Styles and Fundamental Analysis 3 Bubble, Bubble, Toil, and Trouble 6 How Bubbles Work 7 Analysts During the Bubble 8 More Toil and Trouble 8 Fundamental Analysis Anchors Investors 9 The Setting: Investors, Firms, Securities, and Capital Markets 10 The Business of Analysis: The Professional Analyst 12 Investing in Firms: The Outside Analyst 12 | How the Statements Tell a Story 42 Measurement in the Financial Statements 44 The Price-to-Book Ratio 44 Measurement in the Balance Sheet 46 Measurement in the Income Statement 46 The Price-Earnings Ratio 50 Accounting as an Anchor: Don't Mix What You Know with Speculation 51 Tension in Accounting 53 Accounting Quality 54 Summary 55 The Web Compaction 55 |
| Investing within Firms: The Inside Analyst 13 The Analysis of Business 14 Strategy and Valuation 15 Mastering the Details 16 The Key Question: Sustainability of Competitive Advantage 17 Financial Statements: The Lens on | The Web Connection 55 Key Concepts 56 The Analyst's Toolkit 57 A Continuing Case: Kimberly-Clark Corporation 57 Concept Questions 63 Exercises 63 Minicase 69 |
| the Business 17 Choosing a Valuation Technology 18 Guiding Principles 18 Anchoring Value on the Financial Statements 20 | PART ONE FINANCIAL STATEMENTS AND VALUATION 72 |
| How to Use This Book 21 An Outline of the Book 21 The Web Connection 22 Key Concepts 22 | Chapter 3 How Financial Statements Are Used in Valuation 74 |
| A Continuing Case: Kimberly-Clark Corporation 24 Concept Questions 27 Exercises 28 Minicase 30 | The Analyst's Checklist 75 Multiple Analysis 76 The Method of Comparables 76 Screening on Multiples 79 |
| Chapter 2 Introduction to the Financial Statements 32 The Analyst's Checklist 33 | Asset-Based Valuation 82 Fundamental Analysis 84 The Process of Fundamental Analysis 85 Financial Statement Analysis, Pro Forma |
| The Form of the Financial Statements 34 Introducing Nike, Inc. 34 The Balance Sheet 34 | Analysis, and Fundamental Analysis 86 The Architecture of Fundamental Analysis: The Valuation Model 87 |

| Terminal Investments and Going-Concern Investments 88 Valuation Models for Terminal Investments 89 Valuation Models for Going-Concern Investments 91 | Prototype Valuations 142 Valuing a Project 142 Valuing a Savings Account 143 The Normal Price-to-Book Ratio 144 A Model for Anchoring Value on Book Value 145 |
|--|--|
| Criteria for a Practical Valuation Model 91 What Generates Value? 92 Valuation Models, the Required Return, and Asset Pricing Models 96 Summary 97 | Residual Earnings Drivers and Value Creation 147 A Simple Demonstration and a Simple Valuation Model 150 Applying the Model to Equities 151 |
| The Web Connection 97 Key Concepts 98 The Analyst's Toolkit 99 A Continuing Case: <i>Kimberly-Clark Corporation</i> 99 | The Forecast Horizon and the Continuing Value Calculation 152 Beware of Paying Too Much for Growth 155 Converting Analysts' Forecasts |
| Concept Questions 100 Minicases 104 Appendix The Required Return and Asset Pricing Models 106 | to a Valuation 156 Build Your Own Valuation Engine 157 Applying the Model to Projects and Strategies 159 Features of the Residual Earnings Valuation 161 Book Value Captures Value and Residual |
| Chapter 4 Cash Accounting, Accrual Accounting, and Discounted Cash Flow Valuation 110 | Earnings Captures Value Added to Book Value 161 Protection from Paying Too Much for Earnings Generated by Investment 162 |
| The Analyst's Checklist 111 The Dividend Discount Model 111 The Discounted Cash Flow Model 114 Free Cash Flow and Value Added 117 The Statement of Cash Flows 119 The Cash Flow Statement under IFRS 122 Forecasting Free Cash Flows 123 | Protection from Paying Too Much for Earnings Created by the Accounting 163 Capturing Value Not on the Balance Sheet—for All Accounting Methods 164 Residual Earnings Are Not Affected by Dividends, Share Issues, or Share |
| Cash Flow, Earnings, and Accrual Accounting 124 Earnings and Cash Flows 124 Accruals, Investments, and the Balance Sheet 127 | Repurchases 165 What the Residual Earnings Model Misses 165 The Web Connection 165 Summary 165 Key Concepts 166 |
| Summary 129 The Web Connection 129 Key Concepts 130 The Analyst's Toolkit 130 A Continuing Case: Kimberly-Clark Corporation 131 Concept Questions 131 | The Analyst's Toolkit 166 A Continuing Case: <i>Kimberly-Clark Corporation</i> 167 Concept Questions 167 Exercises 168 Minicases 173 |
| Exercises 132 Minicase 138 | Chapter 6 Accrual Accounting and Valuation: Pricing Earnings 178 |
| Chapter 5 Accrual Accounting and Valuation: Pricing Book Values 140 The Analyst's Checklist 141 The Concept Behind the Price-to-Book Ratio 141 Beware of Paying Too Much for Earnings 141 | The Analyst's Checklist 179 The Concept Behind the Price-Earnings Ratio 179 Beware of Paying Too Much for Earnings Growth 180 From Price-to-Book Valuation to P/E Valuation 180 |

| Prototype Valuation 181 | A Continuing Case: Kimberly-Clark Corporation 223 |
|--|--|
| The Normal Forward P/E Ratio 183 | Concept Questions 224 |
| The Normal Trailing P/E Ratio 184 | Exercises 225 |
| A Poor P/E Model 185 | Minicases 229 |
| A Model for Anchoring Value on Earnings 185 | |
| Measuring Abnormal Earnings Growth 187 | |
| A Simple Demonstration and a Simple | PART TWO |
| Valuation Model 188 | THE ANALYSIS OF FINANCIAL |
| Anchoring Valuation on Current Earnings 189 Applying the Model to Equities 190 | STATEMENTS 232 |
| Converting Analysts' Forecasts | |
| to a Valuation 191 | Chapter 8 |
| Build Your Own Valuation Engine 192 | Viewing the Business Through |
| Features of the Abnormal Earnings | the Financial Statements 234 |
| Growth Model 194 | The Anal 22 Charling 225 |
| Buy Earnings 195 | The Analyst's Checklist 235 |
| Abnormal Earnings Growth Valuation | Business Activities: The Cash Flows 236 |
| and Residual Earnings Valuation 195 | The Reformulated Cash Flow Statement 240 |
| Abnormal Earnings Growth | The Reformulated Balance Sheet 241 Business Activities: All Stocks and Flows 242 |
| Is Not Affected by Dividends, | The Reformulated Income Statement 243 |
| Share Issues, or Share Repurchases 196 | Accounting Relations That Govern |
| Accounting Methods and Valuation 196 | Reformulated Statements 243 |
| The Fed Model 197 | |
| PEG Ratios 199 | The Sources of Free Cash Flow and the Disposition of Free Cash Flow 244 |
| Summary 200 | Disposition of Free Cash Flow 244 The Drivers of Dividends 244 |
| The Web Connection 201 | |
| Key Concepts 201 | The Drivers of Net Operating Assets and Net Indebtedness 245 |
| The Analyst's Toolkit 201 | Tying It Together for Shareholders: |
| A Continuing Case: Kimberly-Clark Corporation 202 | What Generates Value? 246 |
| Concept Questions 202 | Build Your Own Analysis Engine 248 |
| Exercises 203 | Summary 250 |
| Minicase 208 | The Web Connection 250 |
| | Key Concepts 251 |
| Chapter 7 | The Analyst's Toolkit 251 |
| Valuation and Active Investing 210 | A Continuing Case: <i>Kimberly-Clark Corporation</i> 252 |
| valuation and Active Investing 210 | Concept Questions 252 |
| The Analyst's Checklist 211 | Exercises 253 |
| How the Fundamental Investor Operates 211 | LACIOISCS 233 |
| Common Misconceptions About Valuation 211 | |
| Applying Fundamental Principles 213 | Chapter 9 |
| Challenging Speculation in the Market Price 213 | The Analysis of the Statement |
| Reverse Engineering the S&P 500 215 | of Shareholders' Equity 258 |
| Challenging the Price of a Stock 218 | * * |
| Reverse Engineering with the Abnormal | The Analyst's Checklist 259 |
| Earnings Growth Model 221 | Reformulating the Statement of Owners' Equity 259 |
| Build Your Own Active Investing Tool 222 | Running with Nike 260 |
| The Web Connection 222 | Reformulation Procedures 260 |
| Summary 222 | Dirty-Surplus Accounting 263 |
| Key Concepts 223 | Comprehensive Income Reporting |
| The Analyst's Toolkit 223 | Under U.S. GAAP and IFRS 265 |

| Ratio Analysis 266 Payout and Retention Ratios 266 Shareholder Profitability 267 | Chapter 11 The Analysis of the Cash Flow Statement 342 |
|--|---|
| Growth Ratios 267 Hidden Dirty Surplus 268 Issue of Shares in Operations 268 Issue of Shares in Financing Activities 272 Handling Diluted Earnings per Share 272 Share Transactions in Inefficient Markets 274 The Eye of the Shareholder 275 Build Your Own Analysis Engine 276 Accounting Quality Watch 276 The Web Connection 278 Summary 278 Key Concepts 278 The Analyst's Toolkit 279 A Continuing Case: Kimberly-Clark Corporation 280 Concept Questions 281 Exercises 282 | The Analyst's Checklist 343 The Calculation of Free Cash Flow 343 GAAP Statement of Cash Flows and Reformulated Cash Flow Statements 345 Reclassifying Cash Transactions 346 Tying It Together 351 Cash Flow from Operations 353 Summary 355 The Web Connection 355 Key Concepts 356 The Analyst's Toolkit 356 A Continuing Case: Kimberly-Clark Corporation 356 Concept Questions 357 Exercises 357 Minicase 362 |
| Minicase 288 | Chapter 12 The Analysis of Profitability 364 |
| Chapter 10 The Analysis of the Balance Sheet and Income Statement 292 | The Analysis of Return on Common Equity 365 First-Level Breakdown: Distinguishing Financing and Operating Activities and the Effect |
| The Analyst's Checklist 293 Reformulation of the Balance Sheet 293 Issues in Reformulating Balance Sheets 294 Strategic Balance Sheets 301 Reformulation of the Income Statement 303 Tax Allocation 304 Issues in Reformulating Income Statements 308 Value Added to Strategic Balance Sheets 312 | of Leverage 366 Financial Leverage 366 Operating Liability Leverage 368 Summing Financial Leverage and Operating Liability Leverage Effects on Shareholder Profitability 370 Return on Net Operating Assets and Return on Assets 371 Financial Leverage and |
| Residual Income from Operations 312 Comparative Analysis of the Balance Sheet and Income Statement 314 Common-Size Analysis 315 Trend Analysis 316 Ratio Analysis 318 Build Your Own Analysis Engine 321 Summary 321 The Web Connection 322 Key Concepts 322 The Analyst's Toolkit 323 | Debt-to-Equity Ratios 373 Second-Level Breakdown: Drivers of Operating Profitability 373 Third-Level Breakdown 376 Profit Margin Drivers 376 Turnover Drivers 376 Key Drivers 379 Borrowing Cost Drivers 380 Build You Own Analysis Engine 381 The Web Connection 382 Summary 382 |
| A Continuing Case: <i>Kimberly-Clark Corporation</i> 324 Concept Questions 325 Exercises 325 Minicases 334 | Key Concepts 382 The Analyst's Toolkit 383 A Continuing Case: <i>Kimberly-Clark Corporation</i> 383 Concept Questions 384 |

| Exercises 385 Minicase 391 | A Modification to Residual Earnings Forecasting: Residual Operating Income 438 The Drivers of Residual Operating Income 441 |
|---|--|
| Chapter 13 The Analysis of Growth and Sustainable Earnings 392 | A Modification to Abnormal Earnings Growth Forecasting: Abnormal Growth in Operating Income 443 Abnormal Growth in Operating Income and |
| The Analyst's Checklist 393 What Is Growth? 393 Warnings About Growth 394 Cutting to the Core: Sustainable Earnings 396 Core Operating Income 396 Issues in Identifying Core Operating Income 397 Core Operating Profitability 404 Core Borrowing Cost 406 Analysis of Growth 407 Growth Through Profitability 407 Operating Leverage 408 Analysis of Changes in Financing 409 Analysis of Growth in Shareholders' Equity 409 Growth, Sustainable Earnings, and the Evaluation of P/B Ratios and P/E Ratios 411 How Price-to-Book Ratios and Trailing P/E Ratios Articulate 411 Trailing Price-Earnings Ratios and Transitory Earnings 414 P/E Ratios and the Analysis of Sustainable Earnings 416 Price-to-Book and Growth 416 Summary 417 The Web Connection 417 Key Concepts 418 The Analyst's Toolkit 419 A Continuing Case: Kimberly-Clark Corporation 419 Concept Questions 420 Exercises 421 | the "Dividend" from Operating Activities 443 Eye on the Future: Sustainable Income 445 The Cost of Capital and Valuation 445 The Cost of Capital for Operations 446 The Cost of Capital for Debt 447 Operating Risk, Financing Risk, and the Cost of Equity Capital 448 Financing Risk and Return and the Valuation of Equity 450 Leverage and Residual Earnings Valuation 450 Leverage and Abnormal Earnings Growth Valuation 451 Leverage Creates Earnings Growth 456 Debt and Taxes 459 Mark-to-Market Accounting: A Tool for Incorporating the Liability for Stock Options in Valuation 461 Enterprise Multiples 463 Enterprise Price-to-Book Ratios 463 Enterprise Price-Earnings Ratios 465 Summary 468 The Web Connection 468 Key Concepts 469 The Analyst's Toolkit 469 A Continuing Case: Kimberly-Clark Corporation 470 Concept Questions 471 Exercises 472 Minicase 477 |
| PART THREE FORECASTING AND VALUATION | Chapter 15 Anchoring on the Financial Statements: Simple Forecasting and Simple Valuation 480 |
| ANALYSIS 434 Chapter 14 The Value of Operations and the Evaluation of Enterprise Price-to-Book Ratios and Price-Earnings Ratios 436 The Analyst's Checklist 437 | The Analyst's Checklist 481 Simple Forecasts and Simple Valuations 482 Introducing PPE, Inc. 482 The No-Growth Forecast and Valuation 483 The Growth Forecast and Valuation 484 Simple Forecasting: Adding information to Financial Statement Information 488 Weighed-Average Forecasts of Growth 488 |

| Simple Valuations with Short-Term and Long-Term Growth Rates 488 Growth in Sales as a Simple Forecast | PART FOUR ACCOUNTING ANALYSIS |
|---|--|
| of Growth 489 | AND VALUATION 552 |
| Information in Analysts' Forecasts 490 Simple Valuation as an Analysis Tool 491 Sensitivity Analysis 491 Reverse Engineering to Challenge | Chapter 17 Creating Accounting Value and Economic Value 554 |
| the Market Price 491 Summary 492 The Web Connection 493 Key Concepts 493 The Analyst's Toolkit 493 A Continuing Case: Kimberly-Clark Corporation 494 Concept Questions 494 Exercises 494 Minicases 500 | The Analyst's Checklist 555 Value Creation and the Creation of Residual Earnings 555 Accounting Methods, Price-to-Book Ratios, Price-Earnings Ratios, and the Valuation of Going Concerns 558 Accounting Methods with a Constant Level of Investment 558 Accounting Methods with a Changing Level of Investment 561 |
| Chapter 16 Full-Information Forecasting, Valuation, and Business Strategy Analysis 504 | An Exception: LIFO Accounting 565 Hidden Reserves and the Creation of Earnings 566 Conservative and Liberal Accounting |
| The Analyst's Checklist 505 Financial Statement Analysis: Focusing the Lens on the Business 505 1. Focus on Residual Operating Income and Its Drivers 506 2. Focus on Change 507 3. Focus on Key Drivers 514 4. Focus on Choices Versus Conditions 515 Full-Information Forecasting and Pro Forma Analysis 515 A Forecasting Template 520 Features of Accounting-Based Valuation 525 Value Generated in Share Transactions 526 Mergers and Acquisitions 527 Share Repurchases and Buyouts 528 Financial Statement Indicators and Red Flags 528 Business Strategy Analysis and Pro Forma Analysis 530 Unarticulated Strategy 530 Scenario Analysis 531 | in Practice 570 LIFO Versus FIFO 571 Research and Development in the Pharmaceuticals Industry 572 Expensing Goodwill and Research and Development Expenditures 573 Liberal Accounting: Breweries and Hotels 574 Profitability in the 1990s 574 Economic-Value-Added Measures 575 Accounting Methods and the Forecast Horizon 575 The Quality of Cash Accounting and Discounted Cash Flow Analysis 576 Growth, Risk, and Valuation 578 Summary 578 The Web Connection 578 Key Concepts 579 The Analyst's Toolkit 579 Concept Questions 580 Exercises 580 Minicase 585 |
| The Web Connection 532 Summary 532 Key Concepts 533 The Analyst's Toolkit 533 A Continuing Case: Kimberly-Clark Corporation 534 Concept Questions 534 Exercises 535 Minicases 542 | Chapter 18 Analysis of the Quality of Financial Statements 590 The Analyst's Checklist 591 What Is Accounting Quality? 591 Accounting Quality Watch 592 Five Questions About Accounting Quality 593 |

| Cutting Through the Accounting: | Strategy and Risk 660 |
|---|--|
| Detecting Income Shifting 594 | Discounting for Risk 660 |
| Separating What We Know from | Price Risk 661 |
| Speculation 597 | Market Inefficiency Risk 661 |
| Prelude to a Quality Analysis 598 | Liquidity Risk 664 |
| Quality Diagnostics 600 | Inferring Expected Returns for Active Investing 664 |
| Diagnostics to Detect Manipulated Sales 603 | Growth-Return Profiles 666 |
| Diagnostics to Detect Manipulation | Finessing the Required Return Problem 667 |
| of Core Expenses 604 | Evaluating Implied Expected Returns with |
| Diagnostics to Detect Manipulation | Value-at-Risk Profiles 667 |
| of Unusual Items 612 | Investing Within Risk Classes 668 |
| Detecting Transaction Manipulation 614 | Beware of Paying for Risky Growth 668 |
| Core Revenue Timing 614 | Expected Returns in Uncertain Times 670 |
| Core Revenue Structuring 614 | Summary 670 |
| Core Expense Timing 615 | The Web Connection 671 |
| Releasing Hidden Reserves 615 | Key Concepts 671 |
| Other Core Income Timing 616 | The Analyst's Toolkit 672 |
| Unusual Income Timing 616 | Concept Questions 672 |
| Organizational Manipulation: Off-Balance- | Exercises 672 |
| Sheet Operations 616 | Minicase 678 |
| Justifiable Manipulation? 617 | _ |
| Disclosure Quality 617 | Chapter 20 |
| Quality Scoring 618 | The Analysis of Credit Risk and Return 680 |
| Abnormal Returns to Quality Analysis 620 | The Amelyst's Charliest 601 |
| Summary 621 | The Analyst's Checklist 681 |
| The Web Connection 621 | The Suppliers of Credit 681 |
| Key Concepts 621 | Financial Statement Analysis for Credit Evaluation 682 |
| The Analyst's Toolkit 622 | Reformulated Financial Statements 682 |
| Concept Questions 623 | Short-Term Liquidity Ratios 684 |
| Exercises 624 | Long-Term Solvency Ratios 686 |
| Minicases 633 | Operating Ratios 687 |
| | Forecasting and Credit Analysis 687 |
| PART FIVE | Prelude to Forecasting: The Interpretive |
| | Background 687 |
| THE ANALYSIS OF RISK | Ratio Analysis and Credit-Scoring 688 |
| AND RETURN 640 | Full-Information Forecasting 692 |
| Chapter 19 | Required Return, Expected Return, and Active |
| - | Debt Investing 695 |
| The Analysis of Equity Risk | Active Bond Investing 696 |
| and Return for Active Investing 642 | Liquidity Planning and Financial Strategy 696 |
| The Analyst's Checklist 643 | The Web Connection 697 |
| The Required Return and the Expected Return 643 | Summary 697 |
| The Nature of Risk 644 | Key Concepts 698 |
| The Distribution of Returns 644 | The Analyst's Toolkit 698 |
| Diversification and Risk 648 | Concept Questions 699 |
| Asset Pricing Models 649 | Exercises 699 |
| Fundamental Risk 651 | Minicase 704 |
| Risk to the Return on Common Equity 653 | A some and disc |
| Growth Risk 654 | Appendix |
| Value-at-Risk Profiling 654 | A Summary of Formulas 709 |
| Adaptation Options and Growth Options 659 | Index 725 |