### Contents

**List of Cases**  xxv  
**List of Accounting Clinics**  xxvi  

#### Chapter 1
**Introduction to Investing and Valuation**  2  
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  
  - 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 Business  17  
Choosing a Valuation Technology  18  
  - Guiding Principles  18  
  - Anchoring Value on the Financial Statements  20  
How to Use This Book  21  
  - An Outline of the Book  21  
The Web Connection  22  
Key Concepts  22  
A Continuing Case: Kimberly-Clark Corporation  24  
Concept Questions  27  
Exercises  28  
Minicase  30  

#### Chapter 2
**Introduction to the Financial Statements**  32  
The Analyst’s Checklist  33  
The Form of the Financial Statements  34  
  - Introducing Nike, Inc.  34  
  - The Balance Sheet  34  
  - The Income Statement  36  
  - The Cash Flow Statement  40  
  - The Statement of Shareholders’ Equity  40  
  - The Footnotes and Supplementary Information to Financial Statements  41  
  - The Articulation of the Financial Statements: 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 Connection  55  
Key Concepts  56  
The Analyst’s Toolkit  57  
A Continuing Case: Kimberly-Clark Corporation  57  
Concept Questions  63  
Exercises  63  
Minicase  69  

#### PART ONE
**FINANCIAL STATEMENTS AND VALUATION**  72  

#### Chapter 3
**How Financial Statements Are Used in Valuation**  74  
The Analyst’s Checklist  75  
Multiple Analysis  76  
  - The Method of Comparables  76  
  - Screening on Multiples  79  
Asset-Based Valuation  82  
Fundamental Analysis  84  
  - The Process of Fundamental Analysis  85  
  - Financial Statement Analysis, Pro Forma Analysis, and Fundamental Analysis  86  
The Architecture of Fundamental Analysis:  
  - The Valuation Model  87
Contents xix

Terminal Investments and Going-Concern
Investments 88
Valuation Models for Terminal Investments 89
Valuation Models for Going-Concern
Investments 91
Criteria for a Practical Valuation Model 91
What Generates Value? 92
Valuation Models, the Required Return, and Asset Pricing Models 96
Summary 97
The Web Connection 97
Key Concepts 98
The Analyst’s Toolkit 99
A Continuing Case: Kimberly-Clark Corporation 99
Concept Questions 100
Exercises 101
Minicases 104
Appendix The Required Return and Asset Pricing Models 106

Chapter 4
Cash Accounting, Accrual Accounting, and Discounted Cash Flow Valuation 110
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
Cash Flow, Earnings, and Accrual Accounting 124
Earnings and Cash Flows 124
Accruals, Investments, and the Balance Sheet 127
Summary 129
The Web Connection 129
Key Concepts 130
The Analyst’s Toolkit 130
A Continuing Case: Kimberly-Clark Corporation 131
Concept Questions 131
Exercises 132
Minicase 138

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
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
Residual Earnings Drivers and Value Creation 147
A Simple Demonstration and a Simple Valuation Model 150
Applying the Model to Equities 151
The Forecast Horizon and the Continuing Value Calculation 152
Beware of Paying Too Much for Growth 155
Converting Analysts’ Forecasts 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 Earnings Captures Value Added to Book Value 161
Protection from Paying Too Much for Earnings Generated by Investment 162
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 Repurchases 165
What the Residual Earnings Model Misses 165
The Web Connection 165
Summary 165
Key Concepts 166
The Analyst’s Toolkit 166
A Continuing Case: Kimberly-Clark Corporation 167
Concept Questions 167
Exercises 168
Minicases 173

Chapter 6
Accrual Accounting and Valuation: Pricing Earnings 178
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
PART FOUR
ACCOUNTING ANALYSIS AND VALUATION 552

Chapter 17
Creating Accounting Value and Economic Value 554

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
An Exception: LIFO Accounting 565
Hidden Reserves and the Creation of Earnings 566
Conservative and Liberal Accounting 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 577

Summary 578
The Web Connection 579
Key Concepts 579
The Analyst's Toolkit 580
Concept Questions 580
Exercises 581
Minicase 586

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
**Contents**

Cutting Through the Accounting:  
Detecting Income Shifting  594  
Separating What We Know from Speculation  597  
Prelude to a Quality Analysis  598  
Quality Diagnostics  600  
Diagnostics to Detect Manipulated Sales  603  
Diagnostics to Detect Manipulation of Core Expenses  604  
Diagnostics to Detect Manipulation of Unusual Items  612  
Detecting Transaction Manipulation  614  
Core Revenue Timing  614  
Core Revenue Structuring  614  
Core Expense Timing  615  
Releasing Hidden Reserves  615  
Other Core Income Timing  616  
Unusual Income Timing  616  
Organizational Manipulation: Off-Balance-Sheet Operations  616  
Justifiable Manipulation?  617  
Disclosure Quality  617  
Quality Scoring  618  
Abnormal Returns to Quality Analysis  620  
Summary  621  
The Web Connection  621  
Key Concepts  621  
The Analyst’s Toolkit  622  
Concept Questions  623  
Exercises  624  
Minicases  633  

PART FIVE  
THE ANALYSIS OF RISK AND RETURN  640  

Chapter 19  
The Analysis of Equity Risk and Return for Active Investing  642  
The Analyst’s Checklist  643  
The Required Return and the Expected Return  643  
The Nature of Risk  644  
The Distribution of Returns  644  
Diversification and Risk  648  
Asset Pricing Models  649  
Fundamental Risk  651  
Risk to the Return on Common Equity  653  
Growth Risk  654  
Value-at-Risk Profiling  654  
Adaptation Options and Growth Options  659  

Strategy and Risk  660  
Discounting for Risk  660  
Price Risk  661  
Market Inefficiency Risk  661  
Liquidity Risk  664  
Inferring Expected Returns for Active Investing  664  
Growth-Return Profiles  666  
Finessing the Required Return Problem  667  
Evaluating Implied Expected Returns with Value-at-Risk Profiles  667  
Investing Within Risk Classes  668  
Beware of Paying for Risky Growth  668  
Expected Returns in Uncertain Times  670  
Summary  670  
The Web Connection  671  
Key Concepts  671  
The Analyst’s Toolkit  672  
Concept Questions  672  
Exercises  672  
Minicase  678  

Chapter 20  
The Analysis of Credit Risk and Return  680  
The Analyst’s Checklist  681  
The Suppliers of Credit  681  
Financial Statement Analysis for Credit Evaluation  682  
Reformulated Financial Statements  682  
Short-Term Liquidity Ratios  684  
Long-Term Solvency Ratios  686  
Operating Ratios  687  
Forecasting and Credit Analysis  687  
Prelude to Forecasting: The Interpretive Background  687  
Ratio Analysis and Credit-Scoring  688  
Full-Information Forecasting  692  
Required Return, Expected Return, and Active Debt Investing  695  
Active Bond Investing  696  
Liquidity Planning and Financial Strategy  696  
The Web Connection  697  
Summary  697  
Key Concepts  698  
The Analyst’s Toolkit  698  
Concept Questions  699  
Exercises  699  
Minicase  704  

Appendix  
A Summary of Formulas  709  
Index  725