Financial Statement Analysis

A Practitioner's Guide

Fourth Edition

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WILEY
John Wiley & Sons, Inc.

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PART FOUR

Forecasts and Security Analysis

Preface to Fourth Edition

This fourth edition of *Financial Statement Analysis,* like its predecessors, seeks to equip its readers for the practical challenges of contemporary business. Once again, the intention is to acquaint readers who have already acquired basic accounting skills with the complications that arise in applying textbook-derived knowledge to the real world of extending credit and investing in securities. Just as a swiftly changing environment necessitated extensive revisions and additions in the second and third editions, new concerns and challenges for users of financial statements have emerged during the first decade of the twenty-first century.

A fundamental change reflected in the third edition was the shift of corporations' executive compensation plans from a focus on reported earnings toward enhancing shareholder value. In theory, this new approach aligned the interests of management and shareholders, but the concept had a dark side. Chief executive officers who were under growing pressure to boost their corporations' share prices could no longer increase their bonuses by goosing reported earnings through financial reporting tricks that were transparent to the stock market. Instead, they had to devise more opaque methods that gulled investors into believing that the reported earnings gains were real.

To adapt to the new environment, corporate managers became far more aggressive in misrepresenting their performance. They moved beyond exaggeration to outright fabrication of earnings through the use of derivatives and special purpose vehicles that never showed up in financial statements and had little to do with the production and sale of goods and services. This insidious trend culminated in colossal accounting scandals involving companies such as Enron and WorldCom, which shook confidence not only in financial reporting but also in the securities markets.

Government responded to the outrage over financial frauds by enacting the Sarbanes-Oxley Act of 2002. Under its provisions, a company's chief executive officer and chief financial officer were required to attest to the integrity of the financial statements. They were thereby exposed to greater risk than formerly of prosecution and conviction for misrepresentation. Sarbanes-Oxley did create a deterrent to untruthful reporting, but as case studies in this new edition demonstrate, users of financial statements still cannot breathe easy.

To help readers avoid being misled by deceptive financial statements, we continue to urge them to combine an understanding of accounting principles with a corporate finance perspective. We facilitate such integration of disciplines throughout *Financial Statement Analysis,* making excursions into economics and business management as well. In addition, we encourage analysts to consider the institutional context in which financial reporting occurs. Organizational pressures result in divergences from elegant theories, both in the conduct of financial statement analysis and in auditors' interpretations of accounting principles. The issuers of financial statements also exert a strong influence over the creation of the accounting principles, with powerful politicians sometimes carrying their water.

As in the third edition, we highlight success stories in the critical examination of financial statements. Wherever we can find the necessary documentation, we show not only how a corporate debacle could have been foreseen through application of basis analytical techniques but also how practicing analysts actually did detect the problem before it became widely recognized. Readers will be encouraged by these examples, we hope, to undertake genuine, goal-oriented analysis, instead of simply going through the motions of calculating standard financial ratios. Moreover, the case studies should persuade them to stick to their guns when they spot trouble, despite management's predictable litany. ("Our financial statements are consistent with generally accepted accounting principles. They have been certified by one of the world's premier auditing firms. We will not allow a band of greedy short sellers to destroy the value created by our outstanding employees.") Typically, as the vehemence of management's protests increases, conditions deteriorate, and accusations of aggressive accounting give way to revelations of fraudulent financial reporting.

A new chapter (Chapter 11) titled "Is Fraud Detectable?" serves as a cautionary note. Some companies continue to succeed in burying misrepresentations in ways that cannot be detected by standard techniques such as ratio analysis. They manage to keep their auditors in the dark or succeed in corrupting them, removing a key line of defense for users of financial statements. By reading the case studies presented in this chapter, readers can observe corporate behavior that puts companies under suspicion by seasoned financial detectives such as short sellers. We also highlight recent research linking financial misreporting to words and phrases used by corporate managers in conference calls with investors and analysts.

As for the plan of *Financial Statement Analysis,* readers should not feel compelled to tackle its chapters in the order we have assigned to them. To aid those who want to jump in somewhere in the middle of the book, we provide cross-referencing and a glossary. Words that are defined in the glossary are shown in bold-faced type in the text. Although skipping around will be the most efficient approach for many readers, a logical flow does underlie the sequencing of the material.

In Part One, "Reading between the Lines," we show that financial statements do not simply represent unbiased portraits of corporations' financial performance and explain why. The section explores the complex motivations of issuing firms and their managers. We also study the distortions produced by the organizational context in which the analyst operates.

Part Two, "The Basic Financial Statements," takes a hard look at the information disclosed in the balance sheet, income statement, and statement of cash flows. Under close scrutiny, terms such as *value* and *income* begin to look muddier than they appear when considered in the abstract. Even cash flow, a concept commonly thought to convey redemptive clarification, is vulnerable to stratagems designed to manipulate the perceptions of investors and creditors.

In Part Three, "A Closer Look at Profits," we zero in on the lifeblood of the capitalist system. Our scrutiny of profits highlights the manifold ways in which earnings are exaggerated or even fabricated. By this point in the book, the reader should be amply imbued with the healthy skepticism necessary for a sound, structured approach to financial statement analysis.

Application is the theme of Part Four, "Forecasts and Security Analysis." For both credit and equity evaluation, forward-looking analysis is emphasized over seductive but ultimately unsatisfying retrospection. Tips for maximizing the accuracy of forecasts are included, and real-life projections are dissected. We cast a critical eye on standard financial ratios and valuation models, however widely accepted they may be.

Financial markets continue to evolve, but certain phenomena appear again and again in new guises. In this vein, companies never lose their resourcefulness in finding new ways to skew perceptions of their performance. By studying their methods closely, analysts can potentially anticipate the variations on old themes that will materialize in years to come.

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Acknowledgments

Mukesh Agarwal
John Bace
Mimi Barker
Mitchell Bartlett
Richard Bernstein
Richard Byrne
Richard Cagney
George Chalhoub
Tiffany Charbonier
Sanford Cohen
Margarita Declet
Mark Dunham
Kenneth Emery
Bill Falloon
Sylvan Feldstein
David Fitton
Thomas Flynn III
Daniel Fridson
Igor Fuksman
Ryan Gelrod
Kenneth Goldberg
Susannah Gray
Evelyn Harris
David Hawkins
Emilie Herman
Avi Katz
Rebecca Keim
James Kenney
Andrew Kroll
Les Levi
Ross Levy
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