WILEY FINANCE

FOURTH EDITION

Financial Statement Analysis Workbook

A Practitioner's Guide

MARTIN FRIDSON
FERNANDO ALVAREZ

Additional Praise for
Financial Statement Analysis, Fourth Edition

"This is an illuminating and insightful tour of financial statements, how they can be used to inform, how they can be used to mislead, and how they can be used to analyze the financial health of a company."

—Jay O. Light, Dean Emeritus, Harvard Business School

"*Financial Statement Analysis* should be required reading for anyone who puts a dime to work in the securities markets or recommends that others do the same."

—Jack L. Rivkin, Director, Neuberger Berman Mutual Funds and Idealab

"Fridson and Alvarez provide a valuable practical guide for understanding, interpreting, and critically assessing financial reports put out by firms. Their discussion of profits—'quality of earnings'—is particularly insightful given the recent spate of reporting problems encountered by firms. I highly recommend their book to anyone interested in getting behind the numbers as a means of predicting future profits and stock prices."

—Paul Brown, Associate Dean, Executive MBA Programs,
Leonard N. Stern School of Business, New York University

"Let this book assist in financial awareness and transparency and higher standards of reporting, and accountability to all stakeholders."

—Patricia A. Small, Treasurer Emeritus, University of California;
Partner, KCM Investment Advisors

"This book is a polished gem covering the analysis of financial statements. It is thorough, skeptical, and extremely practical in its review."

—Daniel J. Fuss, Vice Chairman, Loomis, Sayles & Company, LP

Financial Statement Analysis Workbook

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Finance series contains books written specifically for finance and investment professionals as well as sophisticated individual investors and their financial advisors. Book topics range from portfolio management to e-commerce, risk management, financial engineering, valuation and financial instrument analysis, as well as much more.

For a list of available titles, visit our Web site at www.WileyFinance.com.

Financial Statement Analysis Workbook

Step-by-Step Exercises and Tests to Help You Master Financial Statement Analysis

Fourth Edition

MARTIN FRIDSON
FERNANDO ALVAREZ

WILEY

John Wiley & Sons, Inc.

Copyright © 2011 by Martin Fridson and Fernando Alvarez. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at http://www.wiley.com/go/permissions.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

ISBN 978-0-470-64003-6 (paperback); ISBN 978-1-118-09749-6 (ebk);
ISBN 978-1-118-09747-2 (ebk); ISBN 978-1-118-09748-9 (ebk)

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

In memory of my father, Harry Yale Fridson, who introduced me to accounting, economics, and logic, as well as the fourth discipline essential to the creation of this book—hard work!
M. F.

For Shari, Virginia, and Armando.
F. A.

Contents

Preface to Fourth Edition Workbook

This fourth edition of *Financial Statement Analysis,* like its predecessors, seeks to equip its readers for 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 edition, new concerns and challenges for users of financial statements have accompanied the dawn of the twenty-first century.

For one thing, corporations have shifted their executive compensation plans increasingly toward rewarding senior managers for "enhancing shareholder value." This lofty-sounding concept has a dark side. Chief executive officers who are under growing pressure to boost their corporations' share prices can no longer increase their bonuses by goosing reported earnings through financial reporting tricks that are transparent to the stock market. They must instead devise more insidious methods that gull investors into believing that the reported earnings gains are real. In response to this trend, we have expanded our survey of revenue recognition gimmicks designed to deceive the unwary.

Another innovation that demands increased vigilance by financial analysts is the conversion of stock market proceeds into revenues. In terms of accounting theory, this kind of transformation is the equivalent of alchemy. Companies generate revenue by selling goods or services, not by selling their own shares to the public.

During the Internet stock boom of the late 1990s, however, clever operators found a way around that constraint. Companies took the money they raised in initial public offerings, bought advertising on one another's web sites, and recorded the shuttling of dollars as sales. Customers were superfluous to the revenue recognition process. In another variation on the theme, franchisers sold stock, lent the proceeds to franchisees, then immediately had the cash returned under the rubric of fees. By going out for a short stroll and coming back, the proceeds of a financing mutated into revenues.

The artificial nature of these revenues becomes apparent when readers 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 financial principles, with powerful politicians sometimes carrying their water.

A final area in which the new edition offers a sharpened focus involves 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.

The principles and theories put forth in the University Edition of *Financial Statement Analysis,* fourth edition, are reinforced through the questions and exercises in this workbook. Part One, Questions, provides chapter-by-chapter fill-in-the-blank questions, financial statement exercises, and computational exercises. They are designed to be thought-provoking exercises requiring analysis and synthesis of the concepts covered in the book. In short, these questions do not call for "regurgitation of information."

The answers to all questions can be found in Part Two. Answers are provided in ***boldfaced, italic type*** in order to facilitate the checking of answers and comprehension of the material.

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.

Martin Fridson
Fernando Alvarez

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
Michael Lisk
David Lugg
Jennie Ma
Stan Manoukian
Michael Marocco
Tom Marshella
Eric Matejevich
John Mattis
Pat McConnell
Oleg Melentyev
Krishna Memani
Ann Marie Mullan
Kingman Penniman
Stacey Rivera
Richard Rolnick
Clare Schiedermayer
Gary Schieneman
Bruce Schwartz
Devin Scott
David Shapiro
Elaine Sisman
Charles Snow
Vladimir Stadnyk
John Thieroff
Scott Thomas
John Tinker
Kivin Varghese
Diane Vazza
Pamela Van Giessen
Sharyl Van Winkle
David Waill
Steven Waite
Douglas Watson
Burton Weinstein
Stephen Weiss
David Whitcomb
Mark Zand

PART One

Questions

Questions on Each Chapter

CHAPTER 1: THE ADVERSARIAL NATURE OF FINANCIAL REPORTING

1. Three ways that corporations can use financial reporting to enhance their value are:
   a. ______________________________
   b. ______________________________
   c. ______________________________
2. The true purpose of financial reporting is ______________.
3. Corporations routinely ______________ because the appearance of ______________ receives a higher ______________ multiple.
4. According to the ______________, reversals of the excess write-offs offer an artificial means of ______________ in subsequent periods.
5. The following are some of the powerful limitations to continued growth faced by companies:
   a. ______________________________
   b. ______________________________
   c. ______________________________
6. Some of the commonly heard rationalizations for declining growth are:
   a. ______________________________
   b. ______________________________
   c. ______________________________
7. ______________ reached its zenith of popularity during the ______________ movement of the 1960s. However, by the 1980s, the stock market had converted the ______________ into a ______________.
8. ______________ is one of the ways that the notion of diversification as a means of maintaining ______________ is revived from time to time.

9. The surprise element in Manville Corporation's 1982 bankruptcy was, in part, a function of __________.
10. The analyst's heightened awareness of legal risks are a result of bankruptcies associated with:
    a. __________
    b. __________
    c. __________
11. Some of the stories used to sell stocks to individual investors are:
    a. __________
    b. A "play" in some current economic trend such as
       i. __________
       ii. __________
    c. __________
12. When the story used to sell stocks to individual investors originates among stockbrokers or even __________, the zeal with which the story is disseminated may depend more on __________ than the __________.
13. The ostensible purpose of financial reporting is __________ of a corporation's earnings.
14. Over a two-year period BGT paid L&H $35 million to develop translation software. L&H then bought BGT and the translation product along with it. The net effect was that instead __________, L&H recognized __________.

CHAPTER 2: THE BALANCE SHEET

1. A study conducted on behalf of Big Five accounting firm Arthur Andersen showed that between __________ and __________, book value fell from __________ percent to __________ percent of the stock market value of public companies in the United States.
2. As noted by Baruch Lev of New York University, two examples of how traditional accounting systems are at a loss to capture most of what is going on today are:
    a. __________
    b. __________

3. In the examples in Question 2 there is no accounting event because ________________.
4. Some of the distinct approaches that have evolved for assessing real property are:
   a. ____
   b. ____
   c. ____
5. Some financial assets are unaffected by the difficulties of evaluating physical assets because ________________ in ________________ markets.
6. Under the compromise embodied in SFAS 115, financial instruments are valued according to ________________ by the company________________.
7. If a company wrote off a billion dollars worth of goodwill, its ratio of assets to liabilities would ________________. Its ratio of ________________ would not change, however.
8. Through stock-for-stock acquisitions, the sharp rise in equity prices during the late 1990s was transformed into ________________, despite the usual assumption that ________________.
9. Unlike ________________, goodwill is not an asset that can be readily ________________ to raise cash. Neither can a company enter into a ________________ of its goodwill, as it can with its plant and equipment. In short, goodwill is not ________________ that management can either ________________ or ________________ to extricate itself from a financial tight spot.
10. A reasonable estimate of a low-profit company's true equity value would be ________________.
11. Determining the cost of capital is a notoriously controversial subject in the financial field, complicated by ________________ and ________________.
12. Among the advantages of market capitalization as a measure of equity are:
    a. ____
    b. ____
    c. ____
13. A limitation of the peer-group approach to valuation is that ________________ and therefore ________________ one major benefit of using ________________ as a gauge of actual equity value.