

FINANCIAL STATEMENT ANALYSIS

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Robert F. Halsey

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NINTH EDITION

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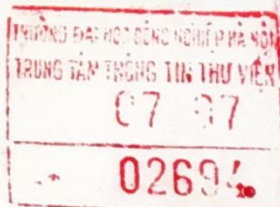
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PREFACE

Welcome to the ninth edition of *Financial Statement Analysis*. This book is the product of extensive market surveys, chapter reviews, and correspondence with instructors and students. We are delighted that an overwhelming number of instructors, students, practitioners, and organizations agree with our approach to analysis of financial statements. This book forges a unique path in financial statement analysis, one that responds to the requests and demands of modern-day analysts. From the outset, a main goal in writing this book has been to respond to these needs by providing the most progressive, accessible, current, and user-driven textbook in the field. We are pleased that the book's reception in the United States and across the world has exceeded expectations.

Analysis of financial statements is exciting and dynamic. This book reveals keys to effective analysis to give readers a competitive advantage in an increasingly competitive marketplace. We know financial statements are relevant to the decisions of many individuals including investors, creditors, consultants, managers, auditors, directors, analysts, regulators, and employees. This book equips these individuals with the analytical skills necessary to succeed in business. Yet, experience in teaching this material tells us that to engage readers we must demonstrate the relevance of analysis. This book continually demonstrates that relevance with applications to real world companies. The book aims to benefit a broad readership, ranging from those with a simple curiosity in financial markets to those with years of experience in accounting and finance.

ORGANIZATION AND CONTENT

This book's organization accommodates different teaching styles. While the book is comprehensive, its layout allows instructors to choose topics and depth of coverage as desired. Readers are told in Chapter 1 how the book's topics are related to each other and how they fit within the broad discipline of financial statement analysis. The book is organized into three parts:

1. Analysis Overview
2. Accounting Analysis
3. Financial Analysis

ANALYSIS OVERVIEW

Chapters 1 and 2 are an overview of financial statement analysis. We introduce financial statement analysis as an integral part of the broader framework of business analysis. We examine the role of financial statement analysis in different types of business analysis such as equity analysis and credit analysis. We emphasize the understanding of business

activities—planning, financing, investing, and operating. We describe the strategies underlying business activities and their effects on financial statements. We also emphasize the importance of accrual accounting for analysis and the relevance of conducting accounting analysis to make appropriate adjustments to financial statements before embarking on financial analysis. We apply several popular tools and techniques in analyzing and interpreting financial statements. An important and unique feature is our use of Dell's annual report as a means to immediately engage readers and to instill relevance. The chapters are as follows:

- *Chapter 1.* We begin the analysis of financial statements by considering their relevance to business decisions. This leads to a focus on users, including what they need and how analysis serves them. We describe business activities and how they are reflected in financial statements. We also discuss both debt and equity valuation.
- *Chapter 2.* This chapter explains the nature and purpose of financial accounting and reporting, including the broader environment under which financial statements are prepared and used. We highlight the importance of accrual accounting in comparison to cash accounting. We identify and discuss myths and truths of these two measurement systems. The importance and limitations of accounting data for analysis purposes are described along with the significance of conducting accounting analysis for financial analysis.

ACCOUNTING ANALYSIS

To aid in accounting analysis, Chapters 3 through 6 explain and analyze the accounting measurement and reporting practices underlying financial statements. We organize this analysis around financing (liabilities and equity), investing (assets), and operating (income) activities. We show how operating activities are outcomes of changes in investing and financing activities. We provide insights into income determination and asset and liability measurement. Most important, we discuss procedures and clues for the analysis and adjustment of financial statements to enhance their economic content for meaningful financial analysis. The four chapters are:

- *Chapter 3.* Chapter 3 begins the detailed analysis of the numbers reflecting financing activities. It explains how those numbers are the raw material for financial analysis. Our focus is on explaining, analyzing, interpreting, and adjusting those reported numbers to better reflect financing activities. Crucial topics include leases, pensions, off-balance-sheet financing, and shareholders' equity.
- *Chapter 4.* This chapter extends the analysis to investing activities. We show how to analyze and adjust (as necessary) numbers that reflect assets such as receivables, inventories, property, equipment, and intangibles. We explain what those numbers reveal about financial position and performance, including future performance.
- *Chapter 5.* Chapter 5 extends the analysis to special intercompany investing activities. We analyze intercorporate investments, including equity method investments and investments in derivative securities, and business combinations. Also, in an appendix we examine international investments and their reporting implications for financial statements.
- *Chapter 6.* This chapter focuses on analysis of operating activities and income. We discuss the concept and measurement of income as distinct from cash flows. We

analyze accrual measures in yielding net income. Understanding recognition methods of both revenues and expenses is stressed. We analyze and adjust the income statement and its components, including topics such as restructuring charges, asset impairments, employee stock options, and accounting for income taxes.

FINANCIAL ANALYSIS

Chapters 7 through 11 examine the processes and methods of financial analysis (including prospective analysis). We stress the objectives of different users and describe analytical tools and techniques to meet those objectives. The means of analysis range from computation of ratio and cash flow measures to earnings prediction and equity valuation. We apply analysis tools that enable one to reconstruct the economic reality embedded in financial statements. We demonstrate how analysis tools and techniques enhance users' decisions—including company valuation and lending decisions. We show how financial statement analysis reduces uncertainty and increases confidence in business decisions. This section consists of five chapters and a Comprehensive Case:

- *Chapter 7.* This chapter begins our study of the application and interpretation of financial analysis tools. We analyze cash flow measures for insights into all business activities, with special emphasis on operating activities. Attention is directed at company and industry conditions when analyzing cash flows.
- *Chapter 8.* Chapter 8 emphasizes return on invested capital and explains variations in its measurement. Attention is directed at return on net operating assets and return on equity. We disaggregate both return measures and describe their relevance. We pay special attention to disaggregation of return on equity into operating and nonoperating components, as well as differences in margins and turnover across industries.
- *Chapter 9.* We describe forecasting and pro forma analysis of financial statements. We present forecasting of the balance sheet, income statement, and statement of cash flows with a detailed example. We then provide an example to link prospective analysis to equity valuation.
- *Chapter 10.* This chapter focuses on credit analysis, both liquidity and solvency. We first present analysis tools to assess liquidity—including accounting-based ratios, turnover, and operating activity measures. Then, we focus on capital structure and its implications for solvency. We analyze the importance of financial leverage and its effects on risk and return. Analytical adjustments are explained for tests of liquidity and solvency. We describe earnings-coverage measures and their interpretation.
- *Chapter 11.* The final chapter emphasizes earnings-based analysis and equity valuation. The earnings-based analysis focuses on earnings quality, earnings persistence, and earning power. Attention is directed at techniques for measuring and applying these concepts. Discussion of equity valuation focuses on forecasting accounting numbers and estimating company value.
- *Comprehensive Case.* This case is a comprehensive analysis of financial statements and related notes. We describe steps in analyzing the statements and the essential attributes of an analysis report. Our analysis is organized around key components of financial statement analysis: cash analysis, return on invested capital, asset utilization, operating performance, profitability, forecasting, liquidity, capital structure, and solvency.

KEY CHANGES IN THIS EDITION

Many readers provided useful suggestions through chapter reviews, surveys, and correspondence. We made the following changes in response to these suggestions:

- **Dell Replaces Kodak as a Featured Company.** Dell provides a healthy growth company to illustrate the analysis; it is also used to explain many business practices and is of interest to a broad audience. Campbell Soup is retained as another company for illustrations and assignments.
- **Return on Invested Capital (Chapter 8) Revised.** Return on equity is decomposed into operating and nonoperating components, reflecting current advances in financial statement analysis. Return on net operating assets (RNOA) is further decomposed into net operating asset turnover and operating profit margin. The operating and nonoperating distinction is important and offers insights into company performance and analysis.
- **Off-Balance-Sheet Financing Discussion Expanded.** Discussion of special purpose entities (SPEs) is expanded to include *variable interest entities* (VIEs) following the passage of new accounting rules for consolidation and their importance in practice.
- **Investments in Marketable and Derivative Securities in Chapter 5.** This edition consolidates all securities investments in one chapter. The analysis of foreign currency disclosures is streamlined and placed in an appendix to Chapter 5.
- **Expanded Discussion of Accrual Accounting.** Accrual accounting is the cornerstone of financial statement analysis. This edition includes further discussion to aid students in their analysis and interpretation of company fundamentals.
- **Pension and OPEB Discussion Simplified.** A revised Chapter 3 focuses more on analysis and interpretation of postretirement benefit disclosures. The detailed accounting mechanics are moved to the appendix.
- **Equity Carve-Outs Included.** Equity carve-outs, spin-offs, and split-offs have increased in frequency as companies seek to unlock shareholder value. Chapter 3 includes a new section to introduce the accounting for and interpretation of them.
- **Comprehensive Case Expanded to Include a Revised Disaggregation of Return on Equity.** Analysis framework in Chapter 8 is extended to the comprehensive case to reinforce the importance of the operating and nonoperating distinction for financial statement analysis.
- **Book is Focused and Practical.** The authors continue to emphasize a streamlined and concise book with an abundance of practical applications and directions for analysis.

INNOVATIVE PEDAGOGY

We believe people learn best when provided with motivation and structure. The pedagogical features of this book facilitate those learning goals. Features include:

- **Analysis Feature.** An article featuring an actual company launches each chapter to highlight the relevance of that chapter's materials. In-chapter analysis is performed on that company. Experience shows readers are motivated to learn when their interests are piqued.

- **Analysis Objectives.** Chapters open with key analysis objectives that highlight important chapter goals.
- **Analysis Linkages.** Linkages launch each chapter to establish bridges between topics and concepts in prior, current, and upcoming chapters. This roadmap—titled *A Look Back*, *A Look at This Chapter*, and *A Look Ahead*—provides structure for learning.
- **Analysis Preview.** A preview kicks off each chapter by describing its content and importance.
- **Analysis Viewpoint.** Multiple role-playing scenarios in each chapter are a unique feature that show the relevance of financial statement analysis to a wide assortment of decision makers.
- **Analysis Excerpt.** Numerous excerpts from practice—including annual report disclosures, newspaper clippings, and press releases—illustrate key points and topics. Excerpts reinforce the relevance of the analysis and engage the reader.
- **Analysis Research.** Multiple, short boxes in each chapter discuss current research relevant to the analysis and interpretation of financial statements.
- **Analysis Annotations.** Each chapter includes marginal annotations. These are aimed at relevant, interesting, and topical happenings from business that bear on financial statement analysis.
- **Analysis Feedback.** End-of-chapter assignments include numerous traditional and innovative assignments augmented by several cases that draw on actual financial statements such as those from Wal-Mart, Kmart, Nike, Reebok, Allied Signal, Lucent Technologies, IBM, Dell, Rite Aid, Motorola, Yahoo!, Baxter International, Columbia Pictures, Abbott, Philip Morris, Merck, and Coca-Cola. Assignments are of four types: *Questions*, *Exercises*, *Problems*, and *Cases*. Each assignment is titled to reflect its purpose—many require critical thinking, communication skills, interpretation, and decision making. This book stands out in both its diversity and number of end-of-chapter assignments. Key check figures are selectively printed in the margins.
- **Analysis Focus Companies.** Entire financial statements of two companies—Dell Inc. and Campbell Soup—are reproduced in the book and used in numerous assignments. Experience shows that frequent use of annual reports heightens interest and learning. These reports include notes and other financial information.

TARGET AUDIENCE

This best-selling book is targeted to readers of all business-related fields. Students and professionals alike find the book beneficial in their careers as they are rewarded with an understanding of both the techniques of analysis and the expertise to apply them. Rewards also include the skills to successfully recognize business opportunities and the knowledge to capitalize on them.

The book accommodates courses extending over one quarter, one semester, or two quarters. It is suitable for a wide range of courses focusing on analysis of financial statements, including upper-level “capstone” courses. The book is used at both the undergraduate and graduate levels, as well as in professional programs. It is the book of choice in modern financial statement analysis education.