

# Contents

<b>Chapter 1 Introduction to Financial Statement Analysis and Valuation.....</b>	<b>7</b>
1.1 Introduction .....	8
1.2 The Business Analysis Process .....	9
1.3 International Financial Reporting Standards .....	12
1.4 Equity-Oriented Stakeholders.....	12
1.5 Outline of the Book .....	13
<b>Chapter 2 Introduction to Accounting and the Annual Reports.....</b>	<b>17</b>
2.1 Introduction .....	18
2.2 The Accounting Equation I: The Statement of Financial Position .....	18
2.3 The Accounting Equation II: The Income Statement .....	22
2.4 The Financial Statements .....	27
2.4.1 The Statement of Financial Position (Revisited).....	28
2.4.1.1 Assets.....	28
2.4.1.2 Liabilities.....	29
2.4.1.3 Equity .....	29
2.4.2 The Income Statement (Revisited) and the Statement of Comprehensive Income .....	33
2.4.2.1 Depreciation expense.....	34
2.4.2.2 Amortization expense .....	37
2.4.2.3 The statement of comprehensive income .....	39
2.4.3 The Statement of Changes in Equity .....	39
2.4.4 The Statement of Cash Flows .....	41
2.5 The Language of Accounting: Debit and Credit .....	52
2.6 Conclusion .....	63
<b>Chapter 3 Strategy Analysis .....</b>	<b>65</b>
3.1 Introduction .....	66
3.2 Macro Factors Affecting the Company's Generation of Future Cash Flows and Risk .....	67
3.3 Industry Factors That Affect the Company's Generation of Future Cash Flows and Risk .....	69
3.4 The Company's Competitive Advantage .....	72
3.5 The Company's Strengths, Weaknesses, Opportunities, and Threats .....	73
3.6 Conclusion .....	74
<b>Chapter 4 Analysis of Accounting Quality .....</b>	<b>77</b>
4.1 Introduction .....	78
4.2 Accounting Quality.....	78
4.3 Accounting Quality for Analysts and Investors.....	80
4.4 Motives for Accounting Manipulation and Earnings Management .....	81

4.5	Different Ways of Manipulating Accounting Information.....	84
4.5.1	Flexible Recognition of Revenues.....	84
4.5.2	Flexible Recognition of Costs.....	85
4.6	Assessment of Accounting Quality.....	86
4.7	Conclusion.....	88

## **Chapter 5 Reformulation of the Income Statement and the Balance Sheet.. 89**

5.1	Introduction.....	90
5.2	Reformulation of the Income Statement and the Balance Sheet.....	90
5.2.1	Reformulation of the Income Statement.....	90
5.2.2	Reformulation of the Balance Sheet.....	99
5.3	Finding the Free Cash Flows.....	108
5.4	Operating or Financing? A Closer Look Through the Reformulation of the Annual Reports of Orkla Group.....	114
5.5	Conclusion.....	137

## **Chapter 6 Cost of Capital and Capital Structure ..... 139**

6.1	Introduction.....	140
6.2	The Weighted Average Cost of Capital.....	141
6.2.1	The Market Value of Net Interest-Bearing Debt.....	142
6.2.2	The Market Value of Equity.....	142
6.2.3	The Corporate Tax Rate.....	145
6.2.4	The Required Rate of Return on Equity.....	145
6.2.4.1	The Risk-Free Interest Rate.....	146
6.2.4.2	The Market Risk Premium.....	147
6.2.4.3	Beta.....	148
6.2.5	The Cost of Debt.....	154
6.3	The Relation Between the Capital Structure and the Cost of Capital.....	166
6.4	Summary.....	167

## **Chapter 7 Profitability Analysis ..... 169**

7.1	Introduction.....	170
7.2	Operating Profitability.....	170
7.2.1	Problems When Making ROIC Comparisons.....	176
7.2.2	The Decomposition of ROIC.....	177
7.2.3	Further Decomposition of ROIC.....	181
7.2.3.1	Indexing.....	181
7.2.3.2	Common Size Analysis.....	183
7.3	Profitability Considering the Capital Structure of the Firm.....	186
7.3.1	The Decomposition of ROE: The Impact of Leverage.....	189
7.3.2	Return on Assets: An Inconsistent Profitability Ratio.....	194
7.4	Summary.....	195

<b>Chapter 8 Growth Analysis .....</b>	<b>197</b>
8.1 Introduction .....	198
8.2 Different Ways to Measure Growth .....	199
8.2.1 Growth in Earnings Per Share .....	203
8.2.2 The Sustainable Growth Rate .....	208
8.3 How Can a Firm Obtain Growth in EVA? .....	211
8.4 Growth and Liquidity .....	214
8.5 Summary .....	216
<b>Chapter 9 Liquidity Analysis.....</b>	<b>217</b>
9.1 Introduction .....	218
9.2 Short-Term Liquidity.....	219
9.3 Long-Term Liquidity .....	224
9.4 Do the Ratios Truly Signal Potential Liquidity Problems? .....	228
9.5 Summary.....	236
<b>Chapter 10 Forecasting .....</b>	<b>237</b>
10.1 Introduction .....	238
10.2 Pro Forma Financial Statements.....	238
10.2.1 Pro Forma Statements with Less Aggregation .....	246
10.2.2 Pro Forma Statements with a Payout Ratio.....	250
10.3 Making Reasonable Assumptions.....	254
10.3.1 Evaluating If Our Assumptions Are Reasonable.....	257
10.4 Considering Sustainability .....	258
10.5 Summary.....	259
<b>Chapter 11 Valuation I: Present Value Models .....</b>	<b>261</b>
11.1 Introduction .....	262
11.2 Future Value and Present Value.....	262
11.2.1 Future Value .....	262
11.2.2 Present Value .....	264
11.2.2.1 Present value of a perpetuity.....	265
11.2.2.2 Present value of a perpetuity with constant growth .....	266
11.3 Present Value Valuation Models .....	267
11.3.1 The Dividend Discount Model .....	267
11.3.2 Discounted Cash Flow Models .....	272
11.3.2.1 The FCFE Model .....	272
11.3.2.2 The FCFF Model .....	273
11.3.2.3 The Cash Surplus Assumption.....	276
11.3.3 Excess Return Models.....	276
11.3.3.1 The Residual Income Model .....	276
11.3.3.2 The Economic Value Added Model.....	278
11.3.3.3 The Clean Surplus Assumption.....	280
11.4 Summary.....	281

<b>Appendix: Analysis of Orkla's profitability, growth, and liquidity.....</b>	<b>283</b>
Forecasts and valuation .....	283
Profitability Analysis.....	285
Growth Analysis.....	290
Liquidity Analysis .....	291
Forecasting.....	292
Valuation .....	296
<b>Chapter 12 Valuation II. Valuation Using Multiples .....</b>	<b>301</b>
12.1 Introduction .....	302
12.2 The Law of One Price .....	302
12.3 Types of Multiples.....	303
12.4 Some Important Multiples .....	305
12.4.1 The Price-to-Earnings Ratio .....	305
12.4.2 Alternatives to the Price-to-Earnings Ratio .....	311
12.4.2.1 The EV-to-NOPAT multiple.....	312
12.4.2.2 The EV-to-EBITA multiple .....	313
12.4.3 The Price-to-Book Ratio .....	313
12.4.4 Alternatives to the Price-to-Book Multiple: The EV-to-NOA Multiple ..	318
12.4.5 The Price-to-Sales and EV-to-Sales Ratios.....	319
12.4.6 Sector-Specific Multiples.....	320
12.5 Using Multiples.....	321
12.6 Summary.....	326
<b>Chapter 13 Valuation of Private Firms.....</b>	<b>329</b>
13.1 Introduction .....	330
13.2 Levering and Unlevering Betas .....	331
13.3 Calculating the Cost of Equity of Private Firms .....	333
13.3.1 Using the Unlevered Betas of Listed Comparable Firms.....	333
13.3.2 Considering Diversification.....	335
13.4 Calculating the Cost of Debt of Private Firms.....	336
13.5 Estimating Growth in Private Firms.....	337
13.5.1 Continuing Growth .....	337
13.6 Illiquidity.....	338
13.7 Applying Multiples to the Valuation of Private Firms .....	339
13.8 Summary.....	340
<b>References .....</b>	<b>341</b>
<b>Terms and Abbreviations .....</b>	<b>343</b>
<b>Equivalence of English and Norwegian Terms.....</b>	<b>350</b>
<b>Index.....</b>	<b>353</b>