Financial Statement Analysis:
Back to the Basics

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CARE Conference
April 2006

Perspective on FSA:
Understanding competitive advantage

◆ RIM provides the anchor for FSA:

$$V_0 = BVE_0 + \sum_{t=1}^{\infty} \frac{(ROE_t - c_e) \times BVE_{t-1}}{(1 + c_e)^t}$$

**Competitive advantage
leaves an economic trace.**

◆ Assume the accounting data are "unmanaged" but perhaps not distortion free.

◆ Does the firm have a competitive advantage?

◆ If so, what is the source and durability of that advantage?

FSA and equity investment settings

Sell-side or buy-side specialist at large institution
- Team of three analysts following just 10 or fewer firms.
- Recommendations and target prices derived from detailed financial model of each covered firm.

Mid-sized money management firm
- Roughly $1 billion under management
- Three analysts covering 50 stocks in the portfolio.
- Universe of 700 or more portfolio candidates (market cap > $4 b).
- Uses third-party valuation & analysis platform as starting point.

Quantitative investment shop
- Three analysts, large and diverse portfolio, rebalanced often.
- Stock selecting driven by multi-factor model of excess returns.

Setting 1:
Specialist at large institution

◆ RIM value estimate driven by forecasted spread, growth, and duration.

Duration

Spread

$$V_0 \;=\; BVE_0 + \sum_{t=1}^{\infty} \frac{\left(ROE_t - c_e\right) \times BVE_{t-1}}{\left(1 + c_e\right)^t}$$

Price target

**Growth: top line, plough back, new investment**

- Build detailed financial model of the company.
- Microscopic examination of financial reports & disclosures.
- Forecasts grounded in rich contextual information.
- Stock recommendation / selection based on V/P

Setting 2:
Mid-sized money manager

- Stock selection again governed by RIM-like value estimate and V/P.

  - **Third-party platforms** provide real-time fundamentals, consensus earnings and sales forecasts, and valuation calculations.

  - **Stock screens** narrow the search for portfolio replacements.

  - **FSA graphs** provide snap-shots of past financial performance and "red flag" alerts.

  - Limited use of traditional microscopic FSA tools and techniques.

  - However, valuation model forecasts must still capture expectations about competitive advantage.

Setting 2:
Applied Finance Group platform

Campbell Soup

Consensus EPS forecasts

Price target

Competitive advantage period

Historical & forecasted CA fade
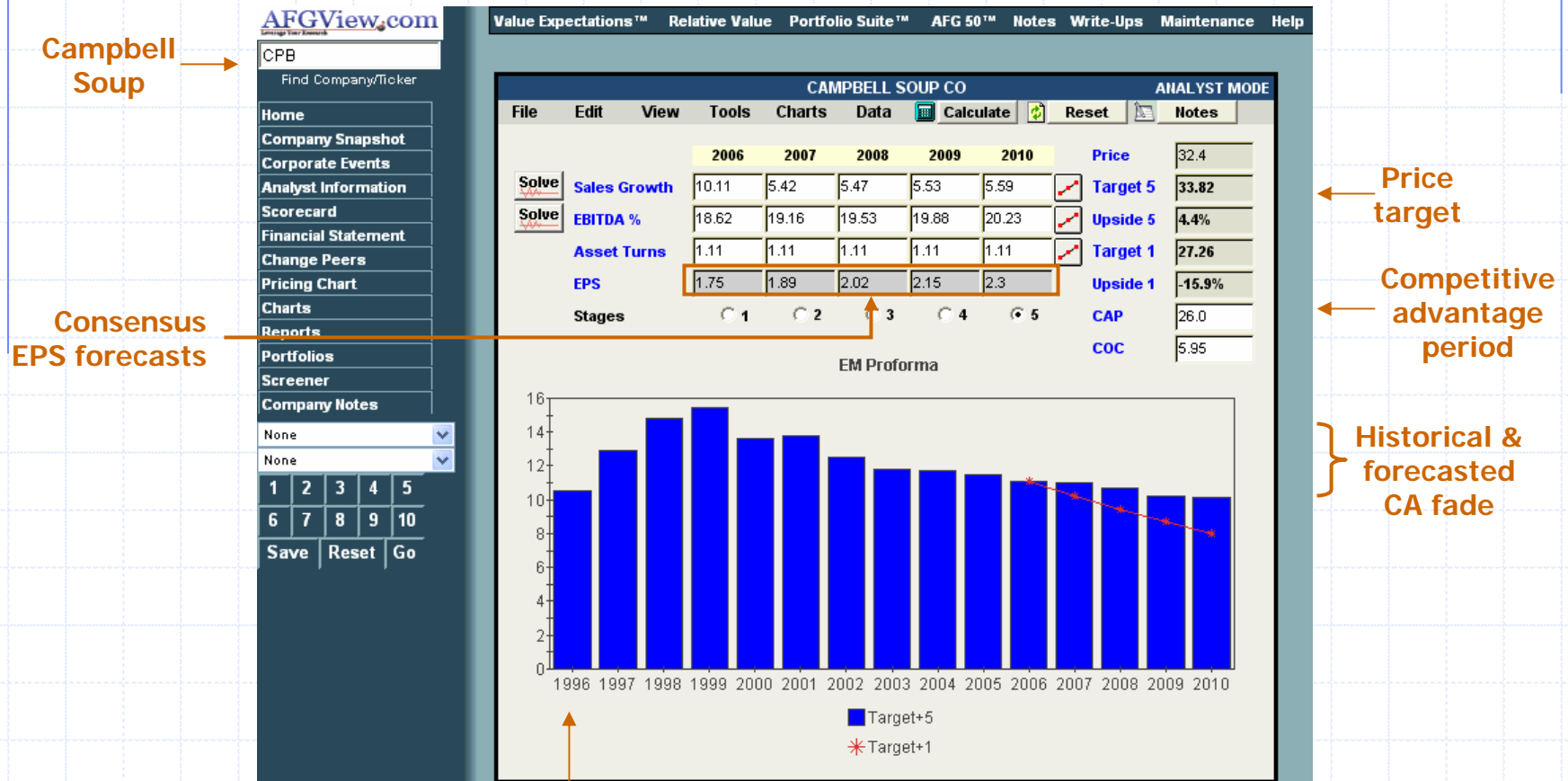
**Proprietary ROC > COC, meaning that CPB enjoys a competitive advantage**

Setting 2:
Starmine's FSA platform
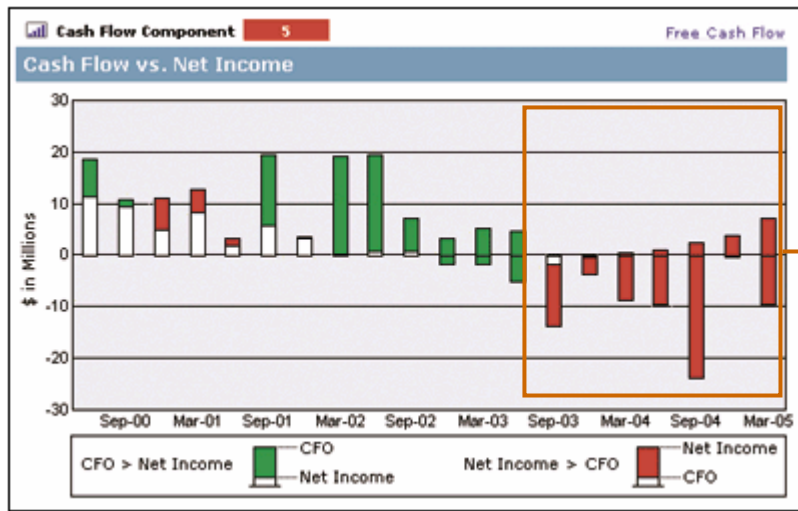
Earnings quality flag

Deteriorating performance when compared to peer firms and sector

- Charts based on Compustat data.

- Intended to help the analyst:
    - Monitor earnings quality.
    - Analyze earnings drivers and sustainability.
    - Compare fundamentals to peers.
    - Recognize financial statement trends.
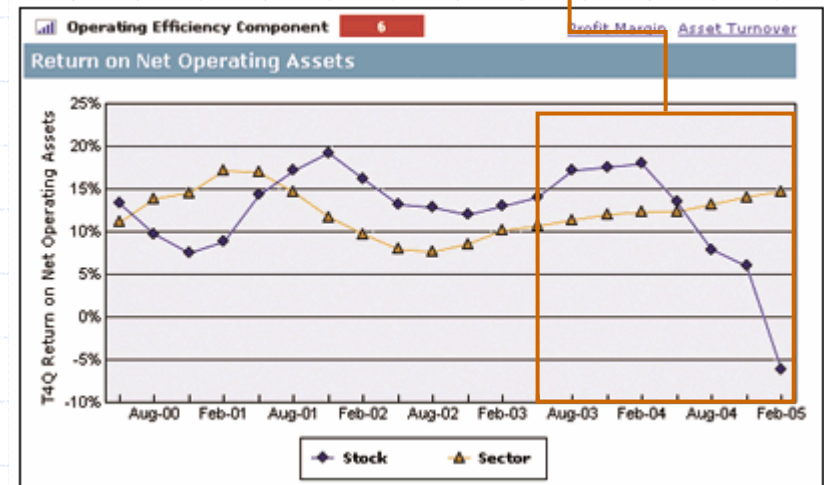
Setting 3:
Quantitative investment shop

◆ Large and diverse stock portfolio built around multi-factor model of fundamentals:

Prudential's PSE Model $$\left(R_t - E\left[R_t \right] \right) = \beta_0 \ + \ \sum_{k=1}^{7} \beta_k \, X_k \ + \ \varepsilon$$

where: **R is the stock's monthly return**   **X4 is ROE momentum**
     E[R] is expected return (e.g. CAPM)   **X5 is margin expansion**
     X1 is earnings surprise (SUE)   **X6 is forward P/E relative to sector average**
     X2 is EPS estimate revision   **X7 is cash flow / assets**
     X3 is relative price strength

- Factor coefficients from historical data on excess returns.
- Composite factor score is used to rank stocks.
- Trading rule specifics are proprietary and not disclosed.

How our work product helps

Specialist at large institution

◆ Explain accounting practices and how to reverse engineer financial statement disclosures.

◆ Identify accounting judgments and potential "quality" distortions.

◆ Describe financial ratios and illustrate their use.

Mid-sized money management firm

◆ Test conjectures about:

- incentives that motivate intentional distortions.
- earnings predictability.
- information content and value relevance of financial statement items.

◆ Uncover empirical regularities:

- among fundamental signals, future earnings and stock returns
- accounting "anomalies".

Quantitative investment shop