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Book Review: Financial Statement Analysis: A Practitioner's Guide, Fernando Alvarez and Martin S. Fridson (Wiley Finance Series, 5th Edition (April 2022), Pages: 448).

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The skill of understanding and analyzing financial statements is essential for business professionals, market practitioners, and investors since it deep dives into the evaluation of the financial health and stability of a business. As a concept, analyzing financial statements may be fundamental since it involves scrutinizing financial reports, both published and unpublished, to review, evaluate, and interpret the company's performance in terms of profitability, liquidity, solvency, and efficiency. Still, it stood the test of time and remains relevant since the business itself and the stakeholders can recognize the strengths and weaknesses of the firm, which helps to make strategic financial decisions irrespective of location, size, and the sector in which the business is operating. Therefore, a helpful workbook to guide the user in assessing the financial statements is required promptly.

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As a comparison piece of work, Financial Statement Analysis: A Practitioner's Guide provides the practitioner with a clearer understanding and interpret the financial statements since it is sophisticated with elementary explanations and an analytical framework that makes it easy for the reader to grab the core ideas in financial theories to scrutinize the financial statements and uncover the reality behind the accounting figures in the statements instead studying the face values on financial statements. Throughout the book, the authors have integrated real-world examples and provided information, adding to each chapter to evaluate the company's performance in the current volatile and uncertain economic outlook. Thus, this book is a veritable treasure since it is a well-organized and exemplified resource that fits the bill if you are looking to introduce yourself to financial statement analysis.

OVERVIEW

The book is divided into four parts and fourteen chapters. Part one, *"Read Between Lines,"* explores the importance, purpose, and key requirement of presenting a financial statement apart from the line presentation of the financial performance of a business. Part Two, *"The Basic Financial Statements,"* focuses on the content of each financial statement and the key disclosures in the Balance Sheet (Statement of Financial Position), the Income Statement, and the Statement of Cashflow. It hardly scrutinizes the issue of valuing tangible and intangible assets, adjusting the debts and equity finance to market value, and issues and techniques to analyze cash flows to assess the company's financial flexibility. Part Three, *"A Closer Look at Profits,"* focused on highlighting how profits (returns) are manipulated and overestimated or window-dressed. Part Four, *"Forecasts and Security Analysis,"* is sophisticated with analytical techniques to forecast and analyze financial statements in terms of credit and equity, using ratio analysis with real-world examples.

The first chapter, titled *"The Adversarial Nature of Financial Reporting,"* provides significant insight into the key objective and purpose for preparing and presenting financial statements and discusses the issues of overt rusting the financial statement figures to make financial decisions with examples. Further, the chapter highlights the conflicts of interest between management and the owners (shareholders) while underscoring the importance of aligning management's decisions with shareholders' interests, particularly when those decisions are based on financial reports. Therefore, the chapter discusses the significance of identifying their profits, earnings, and expenses at realistic values to avoid self-defeating in the long run.

The next chapter by Fernando Alvarez and Martin S. Fridson focuses on a deep analysis of the contents of the balance sheet (Statement of Financial Position). Here the fundamental inadequacies embedded with valuing and presenting balance sheet (financial position) items since some item values are elusive. Thus, it does not recognize the items which are hard to assign a specific value. The authors signify the key limitations of valuing and assessing the balance sheet line items, especially the companies in the technology and mineral sectors, since the values of the tangible and intangible assets are highly subjective while the true value of equity and debt financing significantly depends on market volatility.

Furthermore, chapter thirteen discusses credit analysis. The authors emphasize that financial statement analysts pay attention to evaluating the credit risk of the business. Even though the financial statements present the company's working capital position and the ability to repay the loans, financial statement analysts must assess the solvency of the company and the willingness to repay the loan to show the creditworthiness of the business and develop the credit rating for long term and short-term financial obligations. Therefore, Fernando Alvarez and Martin S. Fridson stress that it is not enough to analyze the financial statement figures when assessing the credit quality of the business; it requires examining the likelihood and the intention to repay debts and the management attitude on debt financing instead of moving towards equity financing to satisfy the company working capital and capital expenditure requirements.

The fourteenth chapter discusses equity analysis in which the authors focus on explaining the use of fundamental analysis techniques (use of financial statements) to evaluate the equity value. However, Fernando Alvarez and Martin S. Fridson highlight that they use additional information that is not presented in the financial statements to evaluate whether the equity has a fair value. For example, the authors stress that the equity value does not only depend on the current year's performances, which are presented in the financial statements, it depends on the future performances of the company. Therefore, analysts must consider the proforma financial statements (proforma income statement, balance sheet, and cash flow statement) to predict future performance and evaluate whether the equity presents a fair value.

Additionally, the authors have broadly discussed several models that can be used to assess equity value. One of the key models that can be used to estimate the equity price is the dividend discount model, which converts the future dividend to present value and considers the growth when measuring the equity price. Furthermore, ratio analysis, especially the price-earnings ratio and earnings per share, can be used to assess operational efficiency.

Chapter three is devoted to discussing of the income statement components. Here, the authors have concerns about evaluating the revenue and expense line items and analyzing the company's operational efficiency. The chapter highlighted how the numbers tell the story of the company's performance. One of the key tools that the authors have used to measure the company performance is the vertical analysis, where all the line items are expressed as a percentage of the *"top line"* (sales or revenue) and named as *"common form income statement."* This technique removes the size and industrial deviations among the companies and makes easy the analysis. Furthermore, they used the Cost of Goods Sold (COGS) as a key figure to present the contrasting operating strategies between companies.

The key argument of Fernando Alvarez and Martin S. Fridson is that sales and net income indicate the key performance of the business; therefore, they state, *"Take care of the top line and the bottom line will take care of itself"* meaning that revenue (top line) of income statement and the profit or a loss (bottom line) are two important figures to assess the operational efficiency of a business. In addition, the authors emphasize that analysts must pay high attention to extraordinary/nonrecurring items and depreciation/amortization figures since they are the major expenses that can be easily manipulated and can highly affect the bottom line.

Following the income statement, chapter four has been reserved to explain the statement of cashflows. Here, the authors stressed that income statements become less relevant when there is a leveraged buyout where the company has been acquired with high debt finance and small equity capital. Therefore, analysts should use cash flow rather than income statements to assess the company performance efficiency in leveraged companies since the cash flow statement evaluates the company's financial flexibility. Similarly, it is important to evaluate which stage the company is in its lifecycle and which financial pitfalls are there the company is vulnerable to.

The fifth chapter, titled *"What is Profit?"* makes an in-depth analysis of company profits. The authors have tried hard to distinguish the Bona Fide Profit and Accounting Profit of the business. Authors have stated *that "After a company earns a bona fide profit, its owners are wealthier than they were beforehand,"* which highlights that there cannot be a bona fide profit without an improvement in shareholder wealth. Despite the bona fide profit, companies compute the accounting profit after adjusting the extraordinary non-operating expenses against the revenue. Therefore, Fernando Alvarez and Martin S. Fridson state that investors and analysts must ignore accounting base earnings since they have been adjusted for depreciations which can easily be manipulated to raise or lower earnings.

Chapter six explains the revenue recognition process, while chapter seven discusses expense recognition. The authors highlight that analysts should stay alert on aggressive revenue, indolent expenditure recognitions, and evidence of fraudulent reporting. They have provided many real-world examples to emphasize the risk of overly revenue recognition by identifying the revenues too early, slowing down the recognition of expenses, and flawed reporting. Hence, the chapters explain the negative consequences of fraudulent recognition of revenues and expenses and present them in the financial statements.

Chapter eight describes the importance of using Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) to evaluate the company's performance. Further, the authors discuss the usage and problem of EBIT (Earnings Before Interest and Tax) versus the EBITDA to assess the Total Enterprise Value and conclude that it is much smarter to calculate the enterprise value as a multiple of EBITDA. Additionally, the authors highlight that using EBITDA to assess the company value with high credit risk is more important than EBIT. However, they highlighted that using only EBITDA may mislead the decision-makers when it is used in the wrong context. Therefore, they suggest to use additional ratios before making financial decisions. Besides, the best indicator for the cash flow analysis to be used as an alternative to operating cash flow is the EBITDA.

Chapter nine by Fernando Alvarez and Martin S. Fridson stresses the reliability of audited financial statements. Here, the authors discuss a series of skirmishes between management and the board of directors in terms of revealing the financial events for the external compensation. The authors have discussed two key issues: first, the conflict between management and the board of directors as the auditor is appointed by the board of directors although the management is the point of contact with auditors. Second, the financial statements do not present a fair picture due to the unraveling of frauds that could not be detected by the auditors.

The tenth chapter discusses the merging and acquisition of companies, where neither method has a significant effect on combining the companies. However, the accounting treatment becomes significant when making financial decisions. The goodwill amortization and valuing of the assets at their real value as combined companies plays a vital role when determining the key decision for merger and acquisition. Therefore, the primary objective of the analysts must be to assess the companies at their fair value and maximize the reported earnings in the post-acquisition period. Chapter eleven, considers fraud detection and takes significant steps to minimize the fraud. There, the authors highlight the key indicators that must be vigilant.

The next chapter has been devoted to discussing forecasting financial statement figures. While estimating and analyzing future financial performances, analysts must consider past figures and the economic trends and changes that significantly influence over the companies. Generally, the projection or forecasting of financial performance and preparing proforma financial statements begins with earnings forecasts. The cash flow followed by balance sheet preparation can be done with cash flow statement figures.

When analyzing revenue behavior, future returns, and security price volatility, accountants and analysts should focus on market deviations, changes in macroeconomic conditions, and structural breaks. Therefore, Fernando Alvarez and Martin S. Fridson stress that financial statement users should be attentive to analyzing past performance and must adjust the trends and changes in the market to predict future financial performances even though it is obvious that analysts cannot predict the uncertainties. Further, the authors stress the importance of sensitivity analysis in adjusting the uncertainties analysis of the effect of volatilities in macroeconomic variables and prepare the proforma financial statements for several years or quarters ahead (income statement, balance sheet, and cash flow statement).

EVALUATION AND CONCLUSION

The book delivers a comprehensive understanding to the reader of the way they should read the financial statements to gather the key idea behind the figures rather than following the line items. Further, Fernando Alvarez and Martin S. Fridson provide many real-world examples and explanations to clarify the sophisticated analytical framework analysts need to scrutinize the company's performance under volatile and uncertain economic conditions. Therefore, professional analysts, teachers, students, and investors greatly benefit from this edition. However, there is room for the edition to be further improved by adding a couple of sections to provide a preliminary understanding of financial statements and a couple of sections to elaborate on the different types of financial statement analysis techniques available to evaluate the business performance and estimate the equity price.

ABOUT THE AUTHORS

Martin S. Fridson is a Chief Investment Officer at Lehmann Livian Fridson Advisors, a New York-based investment management firm founded on fundamental security analysis. He is the past President of the Fixed Income Analysts Society.

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